State Office of Administrative Hearings

Cathleen Parsley
Chief Administrative Law Judge

July 1, 2010

Les Trobman, General Counsel
Texas Commission on Environmental Quality
P.O. Box 13087
Austin Texas 78711-3087

Re: **SOAH Docket No. 582-09-5328; TCEQ Docket No. 2009-0929-UCR; Re: Application of Deer Creek Ranch Water Co., LLC, to Change its Water Rates and Tariff Under Certificate of Convenience and Necessity No. 11241 in Travis and Hays County**

Dear Mr. Trobman:

The above-referenced matter will be considered by the Texas Commission on Environmental Quality on a date and time to be determined by the Chief Clerk's Office in Room 201S of Building E, 12118 N. Interstate 35, Austin, Texas.

Enclosed are copies of the Proposal for Decision and Order that have been recommended to the Commission for approval. Any party may file exceptions or briefs by filing the documents with the Chief Clerk of the Texas Commission on Environmental Quality no later than **July 21, 2010**. Any replies to exceptions or briefs must be filed in the same manner no later than **August 2, 2010**.

This matter has been designated **TCEQ Docket No. 2009-0929-UCR; SOAH Docket No. 582-09-5328**. All documents to be filed must clearly reference these assigned docket numbers. All exceptions, briefs and replies along with certification of service to the above parties shall be filed with the Chief Clerk of the TCEQ electronically at http://www10.tceq.state.tx.us/epic/efilings/ or by filing an original and seven copies with the Chief Clerk of the TCEQ. Failure to provide copies may be grounds for withholding consideration of the pleadings.

Sincerely,

William G. Newchurch
Administrative Law Judge

WGN:nl
Enclosures
cc: Mailing List

STATE OFFICE OF ADMINISTRATIVE HEARINGS

AUSTIN OFFICE
300 West 15th Street Suite 502
Austin, Texas 78701
Phone: (512) 475-4993
Fax: (512) 475-4994

SERVICE LIST

AGENCY: **Environmental Quality, Texas Commission on (TCEQ)**

STYLE/CASE: **DEER CREEK RANCH WATER CO LLC**

SOAH DOCKET NUMBER: **582-09-5328**

REFERRING AGENCY CASE: **2009-0929-UCR**

STATE OFFICE OF ADMINISTRATIVE HEARINGS	**ADMINISTRATIVE LAW JUDGE** **ALJ WILLIAM G. NEWCHURCH**
REPRESENTATIVE / ADDRESS	**PARTIES**
BRIAN MACLEOD STAFF ATTORNEY TEXAS COMMISSION ON ENVIRONMENTAL QUALITY P.O. BOX 13087, MC-175 AUSTIN, TX 78711-3087 (512) 239-0750 (PH) (512) 239-0606 (FAX) bmacleod@tceq.state.tx.us	EXECUTIVE DIRECTOR
DAVID M. GOTTFRIED 1505 WEST SIXTH STREET AUSTIN, TX 78703 (512) 494-1481 (PH) (512) 472-4013 (FAX) david@davidgottfried.com	AGX, INC. ANNE HAWKEN
RANDALL B WILBURN ATTORNEY AT LAW/PROFESSIONAL ENGINEER WILBURN CONSULTING LLC 3000 S. IH 35, SUITE 150 AUSTIN, TX 78704 (512) 326-3200 (PH) (512) 326-8228 (FAX) WILBURNCONSULTING@AUSTIN.RR.COM	DEER CREEK RANCH WATER CO., LLC

JAMES B. MURPHY
ASSISTANT PUBLIC INTEREST COUNSEL
TEXAS COMMISSION ON ENVIRONMENTAL QUALITY
OFFICE OF PUBLIC INTEREST COUNSEL
P. O. BOX 13087, MC-103
AUSTIN, TX 78711-3087
(512) 239-4014 (PH)
(512) 239-6377 (FAX)
jmurphy@tceq.state.tx.us

OFFICE OF PUBLIC INTEREST COUNSEL

JENNIFER JONES
740 GREEN OAK DR.
DRIPPING SPRINGS, TX 78620
(512) 291-7446 (PH)
(512) 291-7446 (FAX)
jbirdrn2000@hotmail.com

JENNIFER JONES

CRISTINA CHAVEZ
610 PANORAMA DR.
DRIPPING SPRINGS, TX 78620
(512) 680-9540 (PH)
info78620@yahoo.com

CRISTINA CHAVEZ

ROYCE H. HENDERSON
108 TWIN CREEK CIRCLE
DRIPPING SPRINGS, TX 78620
(512) 264-1056 (PH)

ROYCE H. HENDERSON

CHRIS ELDER
1020 TANAQUA LN.
AUSTIN, TX 78739
(512) 791-7862 (PH)
(512) 304-8007 (FAX)
chris@lukeparkerhomes.com

CHRIS ELDER

JONATHAN MCCABE
10006 THOMAS LN.
DRIPPING SPRINGS, TX 78620
(512) 924-6665 (PH)
mccabehomes@gmail.com

JONATHAN MCCABE

BRADLEY AND STEPHANIE WEAVER
17202 PANORAMA DR.
DRIPPING SPRINGS, TX 78620

(512) 389-7416 (WK)
(512) 369-6219 (FAX)
bradley.weaver@startran.org

BRADLEY AND STEPHANIE WEAVER

xc: Docket Clerk, State Office of Administrative Hearings

SOAH DOCKET NO. 582-09-5328
TCEQ DOCKET NO. 2009-0929-UCR

APPLICATION OF DEER CREEK RANCH WATER CO., LLC, TO CHANGE ITS WATER RATES AND TARIFF UNDER CERTIFICATE OF CONVENIENCE AND NECESSITY NO. 11241 IN TRAVIS AND HAYS COUNTY	§	BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS

TABLE OF CONTENTS

SOAH DOCKET NO. 582-09-5328
TCEQ DOCKET NO. 2009-0929-UCR

APPLICATION OF DEER CREEK RANCH WATER CO., LLC, TO CHANGE ITS WATER RATES AND TARIFF UNDER CERTIFICATE OF CONVENIENCE AND NECESSITY NO. 11241 IN TRAVIS AND HAYS COUNTY	§ § § § § § §	**BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS**

PROPOSAL FOR DECISION

I. INTRODUCTION

Deer Creek Ranch Water Co., LLC (Applicant or Utility) has applied to increase its rates for the water service it provides under its Certificate of Convenience and Necessity (CCN) No. 11241 in Travis and Hays County, Texas. The Executive Director (ED) of the Texas Commission on Environmental Quality (TCEQ), the Office of Public Interest Counsel (OPIC), and all of the Utility's customers who were admitted as parties in this case (Protestants) oppose the proposed increase.

Because of the complexity of the calculations, the Administrative Law Judge (ALJ) is requesting the ED to recalculate several rate components and to provide those when the ED files exceptions. The ALJ anticipates that the recalculations will show that a small rate increase should be approved, but far less than the Applicant is seeking. That would also mean that a large refund to the customers, plus interest, should be ordered. After reviewing those recalculations and the responses from other parties, the ALJ will refine his proposal when he makes a recommendation on exceptions to the Proposal for Decision (PFD).

II. JURISDICTION

No party disputes the jurisdiction of either the Commission or the State Office of Administrative Hearings (SOAH).

III. PARTIES

The following are the parties in this case:

PARTY	REPRESENTATIVE
Applicant	Randall B. Wilburn
Executive Director (ED)	Brian D. MacLeod
Office of Public Interest Counsel (OPIC)	James B. Murphy
AGX, Inc.	David M Gottfried
Anne Hawken	David M Gottfried
Jennifer Jones	self
Cristina Chavez	self
Royce H. Henderson	self
Chris Elder	self
Jonathan McCabe	self
Bradley and Stephanie Weaver	selves

Except as otherwise noted, AGX, Inc.; Anne Hawken; Jennifer Jones; Cristina Chavez; Royce H. Henderson; Chris Elder; Jonathan McCabe; and Bradley and Stephanie Weaver are referred to collectively as Protestants. AGX, Inc. and Ms. Hawken fully participated in the case through their retained counsel. They coordinated on certain points with other Protestants during the hearing, and there is nothing to indicate any disagreement among the Protestants. For that reason and to simplify writing, the ALJ attributes AGX, Inc. and Ms. Hawken's arguments to all of the Protestants.

IV. PROCEDURAL HISTORY AND PROCESS OBJECTIONS

The following are the key events in this case:

DATE	EVENT
February 27, 2009	Application filed.
February 28, 2009	Notice of rate increase mailed to customers.
May 1, 2009	Effective date of rate increase.
July 31, 2009	Notice of preliminary hearing mailed to customers.[1]
August 13, 2009	Preliminary hearing.
September 4, 2009	Discovery Began.
September 11, 2009	Parties identify applicable statutory and regulatory law.
October 2, 2009	Deadline to serve written discovery requests.
November 6, 2009	Applicant to prefile its direct case in writing, including all testimony and exhibits.
November 20, 2009	Parties other than Applicant and ED to prefile their direct cases in writing, including all testimony and exhibits.
December 23, 2009	ED files his direct case in writing, including all testimony and exhibits.
January 8, 2010	Deadline to take depositions.
January 22, 2010	Deadline to file objections to and motions to strike any prefiled evidence.
January 29, 2010	Deadline to file responses to objections and motions to strike prefiled evidence.
February 5, 2010	Mediated settlement conference. Agreement was not reached during the mediation.
February 12, 2010	Prehearing conference to set times and orders of witnesses and rule on pending objections and motions.
March 22, 2010	Hearing on the merits (HOM) of case began.
March 23, 2010	End of HOM.
April 6, 2010	Transcript delivered.
April 27, 2010	Deadline to file written closing arguments.
May 4, 2010	Deadline to file replies to closing arguments.
July 5, 2010	PFD due date.

In its written closing argument, the Applicant broadly claims that it was denied an opportunity to present rebuttal evidence, while the other parties were given that opportunity. The ALJ does not agree. These arguments were ruled on during the hearing based on the ALJ's prehearing order requiring the parties to prefile direct case evidence, prohibiting the offering during rebuttal of evidence that should have been part of the direct case, and allowing exceptions

[1] ED Ex. C.

when good cause was shown. When exceptions were allowed, the ALJ gave the other parties a full and fair opportunity to respond. The ALJ sees no need to revisit his rulings on these points.

In its reply to closing arguments, the Applicant argues that the ED acted in a slanted and inappropriate way in opposing the application.[2] The ALJ saw nothing of the kind. The ED merely presented the results of his legal and factual analysis of the application, which showed, in the ED's opinion, that the application should be denied. The ALJ does not agree with the ED on every point, but he saw nothing inappropriate.

V. BURDEN OF PROOF

In any proceeding involving any proposed change of rates, the burden of proof shall be on the utility to show that the proposed change, if proposed by the utility, or that the existing rate, if it is proposed to reduce the rate, is just and reasonable.[3] The Applicant has the burden of proof on all issues.

VI. TRANSACTIONS WITH AFFILIATES

The Utility has at least two affiliates that are relevant to this case: Sam Hammett and Deer Creek Ranch, Inc. (Land Company). Mr. Hammett is the General Manager of the Utility. He also is president of and owns shares in the Land Company, which is the managing member of the Utility.[4]

---

[2] To support its complaint, the Applicant cites special rules concerning the ED's role in permitting cases, which are not applicable to this rate setting case. 30 TAC §§ 80.108 & 80.27(a)(4). Even if those rules were applicable, the ED's presentation would not have obviously violated them.

[3] Water Code § 13.184(c).

[4] Applicant Ex. 4 at Application tab at 32, Ex. 11 at 8, Ex. 19 at 8 & Ex. 33 at Promissory Note at 3 & Commercial Pledge and Security Agreement at 1 & 7.

Water Code § 13.002 defines "Affiliated interest" or "affiliate" to mean, among other things:

> (A) any person or corporation owning or holding directly or indirectly five percent or more of the voting securities of a utility;
>
> (B) any person or corporation in any chain of successive ownership of five percent or more of the voting securities of a utility;
>
> (C) any corporation five percent or more of the voting securities of which is owned or controlled directly or indirectly by a utility;
>
> (D) any corporation five percent or more of the voting securities of which is owned or controlled directly or indirectly by any person or corporation that owns or controls directly or indirectly five percent or more of the voting securities of any utility or by any person or corporation in any chain of successive ownership of five percent of those utility securities; and
>
> (E) any person who is an officer or director of a utility or of any corporation in any chain of successive ownership of five percent or more of voting securities of a public utility.

Payment to affiliated interests for costs of any services, or any property, right or thing, or for interest expense may not be allowed either as capital cost or as expense except to the extent that the regulatory authority finds that payment to be reasonable and necessary. A finding of reasonableness and necessity must include specific statements setting forth the cost to the affiliate of each item or class of items in question and a finding that the price to the utility is no higher than prices charged by the supplying affiliate to its other affiliates or divisions for the same item or items, or to unaffiliated persons or corporations.[5]

As discussed below, several expenses that the Applicant claims are for payments to affiliates or are, at least arguably, expenses of the affiliates in whole or in part. The ALJ

---

[5] Water Code § 13.185(e).

scrutinizes each of those transactions very closely and applies the higher standard of review for affiliated transactions.

VII. OVERVIEW OF REVENUE REQUIREMENT DISPUTE

The Commission may not include for ratemaking purposes any expenditure that it finds to be unreasonable, unnecessary, or not in the public interest.[6] Rates are based on a utility's cost of rendering service. The two components of cost of service are allowable expenses and return on invested capital. Only those expenses that are reasonable and necessary to provide service to the ratepayers may be included in allowable expenses. [7] In setting the rates for water service, the Commission must fix a utility's overall revenues at a level that will:

> (1) permit the utility a reasonable opportunity to earn a reasonable return on its invested capital used and useful in rendering service to the public over and above its reasonable and necessary operating expenses; and
>
> (2) preserve the financial integrity of the utility.[8]

The Applicant originally claimed that its adjusted test year revenue requirement was $498,225, but ultimately revised that downward to $403,236.[9] The ED claims that the Utility's revenue requirement is actually only $179,548,[10] and the Protestants claim it is $182,056.[11]

---

[6] Water Code § 13.185(h)(3).

[7] 30 TAC §291.31(a) and (b).

[8] Water Code § 13.183(a).

[9] Applicant Ex. 4 at Spreadsheet tab at 29, Ex. 13 at 29 & Ex. 20 at 13 & 35-36.

[10] ED Ex. 1 at 18 & EP-2.

[11] Tr. 630.

VIII. OPERATIONAL EXPENSES

A. Post Test Year Inflation Adjustments

In computing a utility's allowable expenses, only the utility's historical test year expenses as adjusted for known and measurable changes may be considered.[12] "Test year" means the most recent 12-month period for which representative operating data for a retail public utility are available. A utility rate filing must be based on a test year that ended less than 12 months before the date on which the utility made the rate filing.[13] The test year for this case is July 1, 2007, through June 30, 2008.[14]

The Utility proposes a post-test year inflation adjustment of 10% for many expense items. The other Parties recommend disallowing all of these post-test year adjustments. The ALJ agrees they should be disallowed.

The Applicant argues that adjusting for inflation is a broadly accepted rate setting principle. It notes that the American Water Works Association indicates that an inflation adjustment may be based on many factors, including a change in the number of customers served, changes in water demand, inflation, and changes in operating conditions.[15]

Donald Raushcuber is a professional engineer with deep and broad experience in water resource planning and rate setting.[16] Mr. Raushcuber testified that he expected an annual increase of 8.7% in the number of customers. He based that on historical increases of that

---

[12] 30 TAC §291.31(a) and (b).

[13] Water Code § 13.002(22).

[14] App. Ex. 4 at Spreadsheet tab at 2 & Ex. 20 at 9; ED Ex. 1 at 4.

[15] Applicant Ex. 23.

[16] Applicant Ex. 20 at 4-5.

magnitude and inflation rates in Central Texas having been in the 3-to-5% range, with some items going up as much as 10%.[17]

The other parties correctly argue that in Texas rates are set based on the historic test year.[18] Brent Fenner is a professional engineer with deep experience in the operation and regulation of water utilities as a former employee of the Commission's predecessor and as an owner, manager, consultant, and receiver for water utilities.[19] Mr. Fenner noted that the AWWA manual that the Applicant relies on refers to projecting future expense. He testified that some states, not including Texas, set rates based on projected test years.[20] While the Commission may make post-test year adjustments, they must be based on known and measurable changes.[21] The other parties argue that the Applicant's proposed 10% adjustments are not based on known and measurable changes. The ALJ agrees.

The utility has not offered specific evidence of cost increases that it will encounter in the future for specific items, such as contracts with inflation adjustment clauses. Instead, Mr. Raushcuber has merely speculated that the future will look like the past and inflation will occur. That is not a wholly unreasonable projection but it is not evidence of a known and measurable change.

The ED logically argues that an inflation adjustment based on a projected increase in the number of customers, even if it were known and measurable, would be unbalanced and inappropriate unless an adjustment to revenue was also made. He notes that rates are set to recover adjusted test year costs from the number of customers at the end of the test year. If the number of customers increases after the rates are set, the Utility would recover additional

---

[17] Applicant Ex. at 15; Tr. 238

[18] 30 TAC § 291.31(b)

[19] AGX Ex. B at 1-2.

[20] Tr. 378; Applicant Ex. 23 at 19-20.

[21] 30 TAC § 291.31(b).

revenue from each of the additional customers, thus more than its adjusted test year costs. Thus, a post-test year increase in costs due to additional customers will be offset by additional revenue.

The ALJ agrees with all of the arguments by the other parties. The ALJ concludes that all of the proposed 10% inflation adjustments should be disallowed. To the extent that the Applicant proposes more specific and supported post-test year adjustments to it costs, those are considered below.

B. Salaries and Wages

The Applicant seeks $51,600 for salaries and wages, while the ED recommends $12,915 and the Protestants recommend $30,750. The ALJ agrees with the ED that the salary amount should be reduced to $12,915.

The Applicant contends that it paid $49,200 for salaries during the test year. Chris Aaron, the Applicant's full time licensed water operator, was paid $24,600. Sam Hammett, the Chief Operations Officer, was also paid $24,600. The Utility also included a 5% post-test year adjustment to give each employee a merit and cost of living increase. [22]

The ED's accounting expert, Elsie Pascua, has a B.A. in business administration with a major in accounting. She has 35 years of experience in accounting and related fields. She has worked for the Commission for 13 years analyzing rate increase applications and appeals and has reviewed over 300 of them.[23]

Ms. Pascua found W2s showing that those two employees were only paid a total $24,600 in 2007. That would mean that the Applicant is proposing a 110% increase over that 2007 level.

---

[22] App. Ex. 4 at Spreadsheet tab at 2 and Ex. 20 at 17.

[23] ED Ex. 1 at 1-2.

She testified that she had never seen such large increase in salaries in her 30 years of auditing, budgeting, and accounting. Additionally, Ms. Pascua noted that Deer Creek pays an independent contractor—Professional General Management Services, Inc. (PGMS)—for water operations, office administration, customer service, preparation of annual reports, *etc.* During the test year, the Applicant paid PGMS $57,489.93 for those services, and no party challenges that contract labor expense.[24] She testified that this seemed to duplicate the job functions of Mr. Aaron. Additionally, Aaron's Maintenance, which Chris Aaron owns, provides and was paid for additional services, which created a conflict of interest for Mr. Aaron. The gist of Ms. Pascua's recommendation was that these factors made the salary amounts proposed by the Applicant unreasonable, even if actually paid. She proposed allowing 50% of the 2007 salary amount with a 5% upward adjustment for cost of living, which would be $12,915.[25]

The Utility claims that Ms. Pascua misunderstood. The Utility's accountant, Walter Stewart, testified that the salaries were paid under the tax ID number for the Land Company during the first half of 2007. In the second half of 2007, the Utility had its own tax ID number. That would explain why Ms. Pascua only saw one-half the annual salaries reflected in the Utility's W2s. The total paid for salaries for Utility work during the test year was $49,200, according to Mr. Stewart.[26]

However, Mr. Aaron had his own company, Aaron Maintenance, and the Applicant admitted in discovery responses that he worked ten hours a week for that company.[27] Mr. King also testified that Mr. Aaron worked at least 490 hours per week for the Utility, but admitted that he knew nothing specific about Mr. Aaron's schedule and did not supervise him.[28]

---

[24] Applicant Ex. 4 at Spreadsheets tab at Schedule B.

[25] ED Ex. 1 at 9-10.

[26] Tr. 532-35.

[27] Tr. 323-324.

[28] Tr. 442-444.

The Protestants view the intermingling of records and work for the Utility and the Land Company by Mr. Hammett with suspicion. They question why he was paid the same amount for part time work as Mr. Aaron, who worked full time. They also note that Mr. Hammett lives in Mississippi,[29] making it difficult to believe that he works full time for the Utility in Texas. Their expert, Mr. Fenner, recommends a downward adjustment of 50% of Mr. Hammett's salary.

The ALJ agrees with the ED that the salary amount should be reduced to $12,915. As the ED notes, the Utility has the burden of proof and the evidence is too opaque to find that the $51,600 the Utility seeks is just and reasonable.

Because Mr. Hammett is an affiliate of the Utility, the Applicant must show that the salary paid him is no higher than prices charged by him to its other affiliates or divisions for the same item or items, or to unaffiliated persons or corporations. Under there circumstances, the Applicant was required to show that what the Utility paid Mr. Hammett was no higher than what the Land Company and other entities paid him for comparable services. There is no evidence like that.

Reporting half of the claimed salary amount on the Land Company's books when Mr. Hammett is also the president of that affiliate undermines the assertion that he was actually working for the Utility half time. Mr. Hammett attended the hearing but never testified to explain the scope of his work for the Utility.

Mr. Raushcuber was a credible expert witness on those topics, and Mr. Stewart was a credible witness on accounting matters. They testified that Mr. Hammett worked at least halftime for the Utility. Mr. Raushcuber testified that Mr. Hammett actually represented the Utility 40 hour per week.[30] However, they are outside contractors. How could they know that

---

[29] The ALJ takes judicial notice of this fact, which the Utility's attorney disclosed at the preliminary hearing. Any objection should be filed as an exception to this PFD.

[30] Tr. 610-611.

Mr. Hammett worked so much for the Utility? Especially, when he resides in Mississippi, and there is a full time operator on staff and an outside contractor to handle most of the Applicant affairs.

The ALJ cannot find that the Applicant has shown that: (1) Mr. Hammett worked full time for the Utility; (2) his compensation was just and reasonable for any work he did for the Utility; or (3) his salary complied with the higher standards for affiliated transactions. Under these circumstances, the ALJ finds that the $24,600 for Mr. Hammett's salary should be entirely disallowed.

Similarly, while there is no evidence that he is an affiliate, the evidence shows that Mr. Aaron was paid for one-half the year under the affiliated Land Company's tax ID. That suggests that he was working for the Land Company rather than the Utility. Mr. Stewart testified that Mr. Aaron was never an employee of the Land Company[31] and paying him under the Land Company's tax ID number was only a temporary convenience. Mr. King also testified that Mr. Aaron worked at least 40 hours per week for the Utility. How would they know? Both witnesses are contract vendors who did not work full time for the Utility and did not supervise Mr. Aaron.

The ALJ is not persuaded by the testimony of Mr. Fenner and Mr. King concerning the quantity of Mr. Aaron's work hours for the Utility. He cannot find that Mr. Aaron worked full time for the Utility. He recommends, as does the ED, that one-half of Mr. Aaron's salary be disallowed. No party argues that the 5% post-test year adjustment for a merit raise for Mr. Aaron should be disallowed, so the ALJ agrees it should be included as an adjustment to the cost of service for his salary. Thus, the ALJ agrees with the ED that the salary amount should be reduced to $12,915.

---

[31] Tr. 111.

C. Contract Labor

The Applicant seeks $75,766 for contract labor. The ED recommends that $65,486 be allowed, and the Protestants recommend $63,145. Their proposed disallowances do not completely overlap, so there is more in controversy than would appear just from the numbers they propose. The ALJ finds that $13,000 should be disallowed.

The Protestants' Mr. Fenner recommended deducting $9,000 for contract labor paid to Cutrer Administration. He argued that the work under that contract, performed by Jeanne Cutrer, overlapped with the work performed by PGMS; hence, the smaller amount was unnecessary and should be disallowed.[32] The ED agrees with the Protestants concerning the overlap between the work of Cutrer and PGMS, but takes a more generous approach. Ms. Pascua proposed disallowing $6,500. That includes $2,000 paid to Jean Cutrer—for which there was a check but no invoice—and one-half of the remainder paid Cutrer, $4,500, due to the overlap with PGMS.[33]

The ALJ recommends disallowing the entire $11,000 paid Cutrer Administration. As Ms. Pascua noted, there is a single $2,000 canceled check for a payment to Cutrer, but no invoice or other documents to explain what it was for. That payment also dramatically broke a three-year pattern of paying $750 to Cutrer each month.[34] More importantly, the ALJ cannot find that it was reasonable and necessary to have paid anything to Cutrer Administration. Supposedly Ms. Cutrer worked for the Utility at its office where she handled customer phone calls and billing. But PGMS also handled those tasks. In fact, the phone number and address for the Utility's office, where they might contract Ms. Cutrer, do not appear on customer's bills. Instead, PGMS's phone number and address are printed on the bills.[35]

---

[32] AGX Ex. B at 3.

[33] ED Ex. 1 at 10.

[34] App. Ex. 4 at Spreadsheet tab at Schedule B & Schedule B tab at 5 & sixth to last pages.

[35] Tr. 207; ED Ex. 4.

Given the above evidence, the ALJ cannot find that it was reasonable for such a small Utility to have paid both PGMS and Cutrer for similar and overlapping services. He finds that that the $11,000 paid Cutrer, which was smaller than the $57,489.93 paid PGMS, should be disallowed.

As to Aaron's Maintenance, Ms. Pascua also could not find an invoice or other documents to support $2,000 paid to it. She recommends disallowing that amount.[36] The ALJ agrees. There is no documentation for this amount, and it is dramatically higher than any other amount paid to Aaron's Maintenance. The next highest amount was $440. Additionally, the $2,000 check was made out to Chris Aaron and made no mention of his maintenance company.[37] Under these circumstances, the ALJ cannot find that the $2,000 was either paid to Aaron's Maintenance or was a necessary and reasonable expense to provide water service if it was paid.

The ALJ does not agree that any portion of the remaining amounts paid to Aaron's Maintenance should be disallowed. Ms. Pascua and Mr. Fenner claimed that $350 was paid outside the test year. The actual amount was $305, and, more importantly, the Applicant did not include that amount in its claimed cost of service.[38] The ALJ cannot conclude that $350 should be disallowed. The remaining amounts paid to Aaron's Maintenance during the test year were for the work of day laborers that Mr. Aaron hired to assist with repairs and maintenance. His company passed on that labor cost to the Utility without a mark up. Mr. Aaron included no additional amount for his own work, since he was a salaried employee of the Utility.[39] The ALJ finds that explanation credible and the expenses necessary and reasonable.

Neither does the ALJ agree with Mr. Fenner and Ms. Pascua's suggestion to amortize over two years the $2,876 that the Utility paid to another contractor for tank cleaning during the

---

[36] ED Ex. 1 at 10.

[37] App. Ex. 4 at Spreadsheet tab at Schedule B & Schedule B tab at 5 & fifth last page.

[38] App. Ex. 4 at Spreadsheets tab at Schedule B.

[39] App. Ex. 20 at 18; Tr. 205.

test year. That would result in a disallowance of $1,430.[40] Mr. Fenner testified that tank cleaning is routinely capitalized because it is not performed on a yearly basis.[41] The Applicant correctly argues, however, that a Commission rule requires an annual tank cleaning.[42]

The ALJ also does not agree with Mr. Fenner that $440 spent to clear a site for a new tank should be capitalized as part of the cost of the next tank.[43] The amount is very small, and it is not clear to the ALJ that this was a non-recurring amount solely for a one-time site clearance.

To summarize, the ALJ finds that $13,000 should be disallowed from contract service: (1) the entire $11,000 paid to Cutrer Administration and (2) $2,000 claimed to have been paid to Aaron Maintenance, but for which there was no documentation.

D. Purchased Water

1. Water Purchased From LCRA

The Utility seeks $158,732 for water purchased from LCRA. This is an adjusted test year amount. The ED and the Protestants recommend including zero in the cost of service for water purchased from LCRA. Counterbalancing that, they agree that the other revenue that the Applicant included for the LCRA pass-through charge that customers currently pay should be deleted. The ALJ agrees that the $158,732 expense for water purchased from LCRA should be disallowed and that the related $145,921 of revenue from the pass-through surcharge should be removed from other revenue. The net effect is to disallow $12,811.

---

[40] ED Ex. 1 at 10.

[41] Tr. 344-46.

[42] 30 TAC § 290.46(m)(1).

[43] Tr. 342.

During the test year the Utility spent $98,206.40 to purchase water from LCRA.[44] Those purchases occurred from February 2008 through June 2008. The Utility's witness, Mr. Raushcuber, projected that rate of consumption forward to estimate a full year's consumption. He also made a 10% upward adjustment to account for inflation after the test year.[45] He further estimated that over a full year the Utility would receive $145,921 in revenue from a surcharge that customers are paying for LCRA water. Mr. Raushcuber referred to that as the Pass Through charge, which was authorized following a prior settled case.[46]

Mr. Raushcuber testified that the $12,811 difference between the predicted cost and the predicted revenue represents a connection fee that the Utility's contact with LCRA requires the Utility to pay to reserve raw water, whether taken on not. The Applicant contends that when the surcharge was calculated no amount was included for the connection fee.[47]

Ms. Pascua and Mr. Fenner testified that customers are already paying a pass through charge and should not have to pay twice for the same LCRA water.[48] They never specifically responded to the Utility's argument that the surcharge customers pay does not account for the reservation fee. Instead, Ms. Pascua seemed to agree that the reservation fee should be recovered if just and reasonable.[49]

The ED also argues that the Utility's estimates of costs and revenue for LCRA water are based on post-test year adjustments that are speculative, rather than known and measurable changes. The predicted annual consumption, charges, and payments are based on only five months of test year data, from February through June 2008. The ED argues that those are low

---

[44] Applicant Ex. 4 at Spreadsheet tab at Schedule C & Schedule C tab & Ex. 20 at 19.

[45] Applicant Ex. 20 at 18-19; Tr. 122-126.

[46] Applicant Ex. 20 at 32-33.

[47] Applicant Ex. 20 at 32; Tr. 164-66, 221, 259 & 612-14.

[48] ED Ex. 1 at 10-11; Tr. 295-297.

[49] Tr. 360-361.

water-use months. Additionally, the Utility has included the unsupported 10% inflation adjustment.

The Protestants note that the reservation fee is for future water rights, but the Applicant has not shown that the future water rights are currently used and useful to the Applicant. Both the Protestants and the ED argue that purchased water costs should be collected solely through a surcharge to better match costs rather than be built into base rates.

The ALJ cannot find that any amount should be included in the Utility's cost of service for purchases of water from LCRA. First, the parties settled a prior case in February 2005 and agreed that the tariff would include a pass through provision for wholesale water costs incurred by the Utility.[50] It may be that some costs have not been passed through, but that provision would seem to authorize them to. The ALJ sees no reason to include a component in cost of service and higher base rates based on estimated costs when the Applicant is already authorized to directly pass through and recover the exact costs. Mr. Raushcuber testified that the equation used to set the pass through charge does not include a component for the reservation fee.[51] Perhaps an amendment to the surcharge equation is in order but not inclusion of an estimated true up cost in base rates, which customers would pay in years even if the Utility owed no true up to LCRA.

Second, even if it was appropriate to include a cost of service component for water purchased from LCRA, the proposed cost component is based on several post-test year adjustments, which the Applicant has not shown are known and measurable. At the top of that list is the unsupported inflation adjustment. As discussed earlier, the ALJ cannot find that change is known and measurable.

---

[50] ED Ex. 2 at BDD-5 at Mediated Settlement Agreement at 2.

[51] Tr. 166 & 218; Applicant Ex. 4 at Schedule AA.

The proposed component is not based solely on water use during the test year. The Utility did not beginning receiving water from LCRA until February 2008, which is the seventh month of the test year. The ED argues that February through June are low water-use months. The ED did not cite evidence to support that argument, but the ED does not have the burden of proof. The Applicant, who has that burden, offered no evidence to show that these months are sufficiently typical to allow an entire year's use to be extrapolated from them. They might be less typical than average for rainfall or because they were the first months when water was taken from LCRA. Further, the ALJ sees no basis for assuming that the use of LCRA water would be the same in future years, so that a true up would be due each future year.

Based on the above, the ALJ concludes that the $158,732 that the Applicant seeks to include in cost of service for water purchased from LCRA should be disallowed. Relatedly, he recommends removal of the $145,921 of revenue from the pass through surcharge that the Applicant included in its cost of service calculations.

2. From Other Vendors

Additionally, from May 2006 through March 2008, the Applicant paid $118,812.76 for hauled water from vendors other than LCRA.[52] The Utility does not propose to include this amount in its cost of service or a surcharge to recover it. Because the Utility does not seek to include this amount, the Commission need not adopt findings of fact and conclusions of law concerning them. The ALJ only discusses them below in order to avoid leaving the Commission with a misimpression when it considers a related issue later concerning a customer contribution to invested capital.

The Applicant claims that these expenses for non-LCRA hauled water have consumed all but $48,968 of what the Utility collected from customers under a surcharge approved after the

[52] Applicant Ex. 10.

settlement of another rate case in 2005. This is a different surcharge from the LCRA pass through surcharge previously discussed. Based on that, the Utility claims that only $48,968 should be credited as a customer contribution to invested capital.

As discussed later in the PFD, the ALJ concludes that these surcharge payments under the 2005 settlement were customer contributions in aid of construction and may not be included in the Utility's invested capital. The Commission should not think that crediting the customer contributions against the cost of non-LCRA hauled water, as the Applicant proposes, would be equivalent to using them to reduce the Utility's amount of invested capital.

If the Applicant had proposed to include the costs of the non-LCRA hauled water as a cost of service, the other parties made it clear that they would have recommended that they be disallowed. Of the $118,812.76 paid for non-LCRA water, $36,655.64 was paid before the test year,[53] so that would not have been an allowable expense in this case. The remaining $82,157.12 was paid during the test year, but Mr. Dickey testified that the additional water had to be brought in because the wells that had been drilled to serve the Utility's customers were unable to supply sufficient water. The Utility needed to obtain the additional non-LCRA water to remain in compliance with an agreed temporary order issued by a District Court in Travis County. As part of that order, the Utility had agreed not to connect more than 115 customers, yet it had 300 connections as of February 27, 2007.[54] Based on that, Ms. Pascua and Mr. Dickey recommended or, more accurately would have recommended, disallowing the entire expense of the non-LCRA hauled water.[55] The ED and the Protestants concurred.

---

[53] Tr. 152; Applicant Ex. 10.

[54] ED Ex. 1 at 11 and Ex. 2 at 6-8 and BDD-7, 8 & 9.

[55] ED Ex. 1 at 11 and Ex. 2 at 6-8

E. Water Testing / Chemicals

The Applicant seeks $5,131 for water testing and chemicals, and the other parties do not dispute that amount. The ALJ finds that expense just and reasonable.

F. Utilities (Electrical)

There is no dispute concerning the claimed expense of $8,693 for electric utility service necessary to provide water service. The ALJ recommends inclusion of that amount.

G. Repair and Maintenance

The Applicant seeks to include $4,519 for repair and maintenance, and the Protestants do not challenge that amount. Mr. Raushcuber testified that the Applicant incurred $4,108 in repair and maintenance expenses during the test year. He added a 10% post-test year inflation adjustment of $411.[56] The ED objects to the inflation adjustment.[57] As previously discussed, the ALJ recommends against all of the inflation adjustments. The ALJ concludes that the $411 should be disallowed, and the Applicant's necessary and reasonable repair and maintenance expense is $4,108.

H. Materials and Supplies

The Utility seeks $13,147 for materials and supplies.[58] The ED proposes no disallowance. The Protestants propose to disallow $410, which they claim is a 10% inflation

---

[56] Applicant Ex. 4 at Spreadsheets tab at Table 1 & Schedule F tab and Ex. 20 at 20.

[57] ED Ex. 1 at 11.

[58] Applicant Ex. 4 at Spreadsheet tab at Table 1 and Ex. 20 at 20-21.

adjustment. Mr. Fenner also proposed to remove an additional $2,463 that was spent on equipment and to capitalize it,[59]

The evidence does not show that the Applicant made an inflation adjustment for this expense. Moreover, Mr. Fenner later admitted that capitalizing an individual meter was unusual.[60] The ALJ proposes no disallowance and agrees that $13,147 should be included for materials and supplies.

I. Office Expense

The Applicant claims that it is entitled to $4,066 for office expenses, but the ED and the Protestants recommend disallowing all of it. The ALJ agrees that the entire amount should be disallowed.

The office space is in a building owned by Ward Energy. It was formerly owned by Southwestern Property Management, LLC. Space for both the Utility and the Land Company are included in the same lease, though each has a physically distinct office. The square footage is nearly the same: 175 square feet for the Land Company and 170 square feet for the Utility. The Applicant split the lease expense equally between the Land Company and the Utility.[61]

The ED argues that there is no evidence that the lease has been renewed for the office, so he proposes a post-test year adjustment to delete it.[62] It is true that most of invoices for the office rent indicate that the lease was for "11-1-2005 thru 10-31-2007 (no renewal option)." However, invoices are in evidence for all but two months of the test year. The last of those is for June

---

[59] AGX Ex. B at 4.

[60] Tr. 375.

[61] Applicant Ex. 19 at 7 & Ex. 41 at 8-9.

[62] ED Ex. 1 at 12 & EP-6 at 1; Tr. 477.

2008. That indicates that the lease was extended beyond October 31, 2007, and the Utility continued to rent the space even after the lease term had expired.[63]

The ED urges another argument. He notes that the office space is very small and the Utility also owns a service building where the office could be moved. He argues that the office could even be moved to Mr. Hammett's home.[64] The ED alternatively argues that PGMS, which already provides many contract management services for the Utility, could run the entire operation. That would mean no office space was needed.

In response, the Utility argues that the Water Code directs the Commission to set rates based on a utility's actual costs, not what its costs could have been. It argues that the ED is improperly proposing an ad hoc policy of disallowing the cost of the office space. The Utility claims that the Commission must adopt a rule or rely on a specific statue before setting such a policy.

The ALJ disagrees with the Applicant's ad hoc policy objection. The Commission may not include in rates any expenditure that it finds to be unreasonable or unnecessary.[65] While not using the specific phrase, the ED is clearly arguing that the Applicant's office-space expense is not reasonable or necessary. On this point, the ALJ agrees with the ED.

The ALJ would note that it is extremely unusual—perhaps unprecedented—to disallow a utility's entire office expense, but this is an unusual set of facts. Due to the comprehensive office administration, billing, postage, and customer services provided by PGMS, the ALJ has already found that the office services provided by Cutrer Administration were not reasonable and necessary. Also, as discussed concerning his salary, the evidence does not reasonably show that

---

[63] Applicant Ex. 4 at Schedule H tab.

[64] Applicant Ex. 41 at 5-9; Tr. 664.

[65] Water Code § 13.185(h)(3).

Mr. Hammett worked for the Utility full time. Given that, it is unclear why the Utility reasonably needed an office to serve its small number of customers during the test year, especially when it had a service building on site to serve as a modest office.

The ALJ cannot find that the office space was a reasonable and necessary expense during the test year. He finds that the entire office space expense of $4,066 should be disallowed.

J. Auto Expense

The Utility argues that its just and reasonable auto expense is $2,830. That is approximately 50% of the cost of a mortgage loan paid for a Ford F150 truck.[66] It is undisputed that the truck was purchased in 2006 and has been used by two affiliates of the Utility: the Land Company and Mr. Hammett, for personal use.[67]

No party questions the original cost of the truck or the allocation of 50% of that cost to the Utility. Nevertheless, the ED and the Protestants both recommend deleting the truck expense from cost of service. The ED's Ms. Pascua and Mr. Dickey advocate transferring 50% of the depreciated value of the truck, $15,078, to invested capital.[68] That would give the Utility both a return on the net plant value of the truck and an annual deprecation expense.

Protestants' witness, Mr. Fenner, does not recommend capitalizing the cost of the truck.[69] He did not explain why. For the Applicant, Mr. Raushcuber argued that in his experience small costs, like the remaining value of the truck, are treated as annual expenses and not capitalized.[70]

---

[66] Applicant Ex. 20 at 21.

[67] Tr. 182.

[68] ED Ex. 1 at 12 and Ex. 2 at 17.

[69] Tr. 302 and 406.

[70] Tr. 621.

However, Mr. Dickey's depreciation analysis on the truck indicates that it has a 20-year useful life. That suggests capitalization is the more appropriate treatment.

The ALJ agrees that ED's approach is more correct. He recommends disallowing the entire $2,830 that the Applicant included for the truck expense and adding the truck's $15,078 remaining net value to invested capital, with a service life of 20 years, which will yield a return on that value and an additional annual depreciation of $850.

K. Auto Expense Gasoline

The Applicant seeks $1,525 in auto gasoline expenses. To account for its use by the affiliates, 50% of the actual test year gasoline expense for the F150 truck is included. The Applicant increased that amount by 10% to account for estimated post-test year inflation.[71] The Protestants do not question the expense. The ED recommends removing the inflation adjustment, leaving $1,386 for this category.[72] The ALJ agrees with the ED's recommendation.

L. Telephone Expense

The Utility claims a telephone expense of $3,861, which includes the cost of Mr. Aaron's cell phone, an office phone, and internet and long distance services. Mr. Raushcuber deducted the expense of Mr. Hammett's cell phone because he found that the affiliated Land Company actually paid for it. No inflation adjustment was included.[73]

---

[71] Applicant Ex. 20 at 22.

[72] ED Ex. 1 at 11 & 12.

[73] Applicant Ex. 4 at Spreadsheets tab at Schedule J, Ex. 19 at 9-10 & Ex. 20 at 22.

The Protestants recommend allowing only $1,247,[74] but the ALJ can find no evidence or argument to support that recommendation. The ED argues that the telephone expense should be $2,522, half of the $5,249 total. He argues that the other half should be allocated to the affiliates who also use the telephone services.[75] The ED offered no evidence to show and the invoices in the application do not indicate that the telephone expenses were for the benefit of affiliates, other than the cost of Mr. Hammett's cell phone which was removed.

The ALJ agrees with the Applicant that its necessary and reasonable telephone expense should be $3,861.

M. Printing Expense

The Utility claims a $352 printing expense, which includes the test year amount of $320 and a 10%, $30 inflation adjustment.[76] The ED and the Protestants recommend disallowing the inflation adjustment.[77] The ALJ agrees that the $30 inflation adjustment should be disallowed.

N. Equipment Rental Expense

The Applicant seeks to include $5,083 for equipment rented during the test year to repair and maintain its water system. It proposes no inflation adjustment to this expense.[78] The ED recommends no disallowance.

The Protestants argue the entire expense should be disallowed. Mr. Fenner agreed that it would be necessary and reasonable for a utility to rent equipment to make repairs to its system,

---

[74] AGX Ex. B at BWF-2.

[75] ED Ex. 1 at 12.

[76] Applicant Ex. 20 at 17.

[77] ED Ex. 1 at 12 & EP-6 at 1; AGX Ex. B at 4.

[78] Applicant Ex. 20 at 23.

but he could not agree that the Applicant owned no equipment.[79] He also testified that the Applicant did not offer any documentation to support this expense or evidence that equipment would need to be rented in the future.[80]

Mr. Raushcuber testified that this expense was for equipment rental,[81] but he is an outside consultant retained to prepare the application. There is no evidence that he had direct personal knowledge of the underlying transactions.

The only documentary evidence offered to support the equipment rental expense is a series of cryptic transactions with "DRIPPING SPRINGS RENDRIPPING SPRINGS TX" on what appear to be American Express Card statements for the account of "SAM J HAMMETT DEER CREEK RANCH INC" concerning the "Activity for CHRIS AARON."[82] When totaled, those transactions come to $5,082.68.[83] Even if those were rental transactions, there are no accompanying invoices to explain what was rented or for what purpose. Moreover, the transactions appear on the credit card statement of two affiliates, Mr. Hammett and the Land Company, not the Utility. As discussed throughout this case, the affairs and the expenses of the Utility and those affiliates are intertwined frequently and complexly.

The ALJ cannot find that the evidence is sufficient to show that the transactions totaling $5,082.68 were for equipment rental or even for the Utility. Even if they were, the evidence is insufficient to show what the equipment was used for or that the Utility reasonably needed to rent the equipment to provide service. The ALJ recommends that the entire $5,083 claimed by the Applicant for equipment rental be disallowed.

---

[79] Tr. 382-83.

[80] AGX Ex. B at 4-5.

[81] Applicant Ex. 20 at 23.

[82] Applicant Ex. 4 at Schedule F tab.

[83] Applicant Ex. 4 at Spreadsheets tab at Schedule F, Column G.

O. Insurance Expense

The Applicant claims that its test year insurance expense was $13,240. It adjusts that upward to $14,559 to account for anticipated post-test year inflation of 10%. It claims that the insurance expense is for health insurance for the Utility's employees and for general and facility damage insurance.[84]

The ED claims the insurance expense should be reduced to $7,751, and the Protestants claim it should be lowered to $7,887. Though he does not agree with all of the ED's reasoning, the ALJ does agree with the ED that the insurance expense should be reduced to $7,751.

No party questions the general and damages insurance, which totals $2,266.06, paid to Galloway Insurance.[85] The ALJ finds that should be allowed.

Ms. Pascua and Mr. Fenner both testified that the inflation adjustment of $1,324 should be disallowed because it is unsupported.[86] The ALJ agrees.

The Utility paid $3,417 during the test year to Union Insurance for vehicle insurance.[87] Ms. Pascua proposes to disallow 50% of that amount.[88] That recommendation is in harmony with her and Mr. Dickey's allocation of only 50% of the cost of the F150 truck to the Utility to account for the fact that it was also used by the Land Company and Mr. Hammett.[89]

---

[84] Applicant Ex. 20 at 23; Tr. 621-22.

[85] Applicant Ex. 4 at Spreadsheets tab at Schedule L.

[86] ED Ex. 1 at 13 & EP-6 at 1-2; AGX Ex. B at 5.

[87] Applicant Ex. 4 at Spreadsheets tab at Schedule L.

[88] ED Ex. 1 at 13 and EP-6 at 2.

[89] ED Ex. 1 at 12 and Ex. 2 at 17.

As noted elsewhere, the Utility's expert, Mr. Raushcuber, agreed that only 50% of the cost of the truck should be allocated to the Utility, though he disagreed that the truck's cost should be capitalized.[90] Yet the Applicant did not propose a similar 50% adjustment to the auto insurance expense. The ALJ agrees with Ms. Pascua that 50% of the auto insurance expense, $1,709, should be disallowed due to the use of the truck by the affiliates.

That leaves in dispute a claimed test year expense of $7,552.55 for health insurance. The only evidence indicating whose health insurance the Utility paid for was a bare statement by Mr. Raushcuber: "This line item includes health insurance costs for employees . . ."[91] Ms. Pascua testified that she reviewed the health insurance policy and found that it also covered Susan Hammett, who is not an employee of the Utility. Because she concluded a non-employee was covered by the health insurance, Ms. Pascua recommended disallowing 50% of that expense.[92]

The Applicant did not offer the policy to rebut Ms. Pascua's testimony that it covers Susan Hammett. Instead, Mr. Raushcuber stated that he reviewed the canceled checks in evidence and could find no reference to Susan Hammett. He referred to "Ms. Hammett," which suggests that Susan is Sam Hammett's wife.[93] The Applicant relies on that lack of reference to Susan Hammett in the canceled checks to argue that Ms. Pascua's disallowance must fail.

The canceled checks for the health insurance payments were included in the application and are in evidence.[94] It is true that they do not refer to Susan Hammett. More importantly, they contain no information indicating who was covered by the insurance. It is not impossible that Ms. Pascua was mistaken when she said the policy covered Susan Hammett, but the Utility did

---

[90] Applicant Ex. 20 at 21.

[91] Applicant Ex. 20 at 23.

[92] ED Ex. 1 at 13 and EP-6 at 1; Tr. 499-500.

[93] Tr. 621.

[94] Applicant Ex. 4 at Schedule L tab.

not offer the policy or other evidence to rebut Ms. Pascua's testimony. The ALJ cannot find that the lack of reference to Susan Hammett in the canceled checks is sufficient to overcome Ms. Pascua's testimony that the policy covers Susan Hammett.

Should the health insurance disallowance be greater than the 50% Ms. Pascua recommended? Mr. Fenner testified that he recommended several disallowances that flowed from his proposed salary adjustments, including one to insurance.[95] The ALJ could not understand the method that Mr. Fenner used or the amount of health insurance disallowance he proposed.

As previously discussed, the ALJ concluded that Mr. Hammett's entire salary paid by the Utility should be disallowed. That was because the Applicant did not show that Mr. Hammett worked full time for the Utility and the expense of his salary was just, reasonable, and complied with the higher standards for affiliated transactions. The ALJ also concluded that 50% of Mr. Aaron's salary should be disallowed because he could not find that Mr. Aaron worked full time for the Utility. Although those are the only two claimed employees, the ALJ does not conclude that a similar 75% disallowance of the health insurance expense is appropriate. There is no evidence that the health insurer is an affiliate of the Utility, so the higher standard of review is not applicable. It would not necessarily follow that the Utility would pay for none of Mr. Hammett and Mr. Aaron's health insurance even if they worked less than full time.

The ALJ recommends that the Commission disallow 50% of the claimed health insurance expense as suggested by Ms. Pascua. The facts are messy, but that strikes the ALJ as a reasonable disallowance given the disputed but unrebutted evidence that Susan Hammett was covered by the policy and the fact that both Mr. Hammett and Mr. Aaron were employees of the Utility, even if their full salaries were not shown to be allowable expenses.

---

[95] Tr. 295.

To summarize, the ALJ recommends allowing $7,751 as an insurance expense: $2,266 for general and damages insurance, $1,709 for auto insurance, and $3,776 for health insurance.[96]

P. Postage Expense

The Applicant seeks to include $423 in its cost of service for postage expense. This includes the $385 that it actually spent during the test year and a 10% inflation adjustment. The ED and the Protestants oppose the inflation adjustment.[97] The ALJ agrees that the inflation adjustment should be disallowed. He concludes that the Applicant's necessary and reasonable postage expense is $423.

Q. Payroll Tax Expense

The Applicant seeks to include $4,030 in its cost of service for its payroll taxes. This includes a claimed actual test year expense of approximately $3,840 and an adjustment to account for post-test year salary inflation that it anticipates. Mr. Raushcuber testified that he multiplied the salary inflation adjustment amount by 7.65% to calculate the related post-test year adjustment to payroll tax expense.[98] The application also includes completed tax forms to support the payroll tax amounts claimed and to demonstrate how payroll taxes are calculated.[99]

The ED recommends a $2,592 payroll tax amount, and the Protestants recommend $2,353. Mr. Fenner testified that $190 of his proposed disallowance was to remove the Applicant's claimed but unsupported salary inflation related adjustment. He agreed with Mr. Raushcuber that the adjustment to salaries leads to an adjustment to the payroll tax

---

[96] The deviation from the ED's recommendation appears to be due to repeated rounding off of subtotals.

[97] ED Ex. 1 at 12 & EP-6 at 1; AGX Ex. B at 5.

[98] Applicant Ex. 20 at 24; Tr. 622.

[99] Applicant Ex. 4 at Spreadsheet tab at Schedule N & Schedule N tab.

amount.[100] Ms. Pascua testified that the ED's proposed disallowance corresponded to her proposed adjustments and reductions to salaries and wages.[101]

The ALJ concludes that a portion of the payroll tax amount the Applicant seeks should be disallowed. The payroll tax amount should be 7.65% of the salary amount. Since the ALJ finds that the allowable salary amount is $12,915, he finds that the allowable payroll tax amount is 7.65% of that, or $988.

R. Property and Other Taxes

Under 30 TAC § 291.31(b)(1)(C), allowable expenses, to the extent they are reasonable and necessary, and subject to that section, may include, assessments and taxes other than income taxes. The Utility originally sought to include $8,770 in cost of service for property taxes, which included $7,970 claimed test year taxes and an $800, 10% post-test year inflation adjustment. It later reduced that to $7,110. That includes claimed test year taxes of $6,470 and a 10% inflation adjustment of $640. The Utility reduced its claim when it conceded that it should not have included taxes on property owned by the Land Company and leased to the Utility. [102]

Mr. Fenner testified that $6,310 should be allowed. That is because he deducted the original inflation adjustment of $800 from the Applicant's reduced claim or $7,110, rather than only the $640 for inflation included in the $7,110.[103] The ALJ agrees that the inflation adjustment should be disallowed, but does not agree with the amount Mr. Fenner recommends.

Ms. Pascua recommended deducting both the taxes paid on the Land Company's property and the inflation adjustment. However, she would allow only $6,152, while Mr. Raushcuber

---

[100] AGX Ex. B at 5; Tr. 295 & 384-385

[101] ED Ex. 1 at 15.

[102] Applicant Ex. 20 at 24-25.

[103] AGX Ex. B at 5-6.

allowed $6,470. That is because Ms. Pascua calculated the tax amount based on tax receipts, not canceled checks.[104]

The ALJ agrees with Ms. Pascua's more detailed calculation based on the tax receipts. He concludes that $6,152 should be allowed for property and other taxes.

S. Miscellaneous Expense

The Utility claims that it had minor miscellaneous expenses of $683 during the test year for supplies, TCEQ inspections, and solid waste disposal. It does not propose an inflation adjustment.[105] The ED and the Protestants do not dispute the $683, and the ALJ concludes it should be included in cost of service.

T. Loans

The Applicant originally sought to include $13,932 in cost of service for interest payments to Wells Fargo Bank and interest and principle payments to Mr. Hammett for loans allegedly borrowed to pay for operation and maintenance expenses. The other parties recommended disallowing this entire amount,[106] and the Utility later agreed to do so.[107]

Similarly, the Utility originally included $95,809 for interest payments on funds allegedly borrowed from Frost Bank for capital projects, but it later withdrew that request in the face of opposition from the other parties.[108]

---

[104] ED Ex. 1 at 15-16 and EP-12.

[105] Applicant Ex. 20 at 25.

[106] ED Ex. 1 at 14-15 & AGX Ex. B at 6.

[107] Applicant Ex. 20 at 25-26.

[108] Applicant Ex. 20 at 26-27; ED Ex. 1 at 14-15 & AGX Ex. B at 6.

Since both of these expense items have been withdrawn, there is no need for the ALJ to make recommendations concerning them. However, the loan from Frost Bank is also discussed in the portion of the PFD concerning return on invested capital.

U. Professional Fees

The Applicant seeks $13,380 in cost of service for professional fees that it incurred during the test year. That includes $2,560 for accountant's fees, $9,330 for routine attorney's fees, and $1,520 for five years to recover $7,588 spent on attorney's fees related to the Applicant's last rate case, which was settled.

The ED recommends that $10,386 be disallowed. The Protestants recommend disallowing $6,482, but also suggest allowing $1,322 per year for five years to recover $6,122 of non-recurring attorney's fee.

The ED argues that 50% of the accounting work expense should be disallowed because it was for both the Utility and the Land Company. The ALJ agrees with the ED.

The accounting work was performed during the test year, July 1, 2007, through June 30, 2008, but it concerned a tax return for a prior tax year. The Utility argues that Mr. Stewart, the accountant who did the work, testified that the work was only for the Utility. However, on the transcript page to which the Applicant points,[109] the ALJ found no such testimony. Instead, Mr. Stewart stated that the work was performed during the test year on a corporate income tax return for a prior tax year, but he did not say which entity's tax return.[110]

---

[109] Tr. 107.

[110] Tr. 107-08.

As discussed above under salaries, the Utility did not have its own tax ID number prior to the second half of 2007, when the test year began. That was because for tax purposes the Land Company and the Utility were treated as one entity.[111] Given that, the tax work that Mr. Stewart performed for a year before the test year must have been for the combined entity, not just the Utility. Additionally, the invoice for the accounting work was mailed to the Land Company, not the Utility.[112] In absence of more specific evidence tying the tax work solely to the Utility, the ALJ agrees with the ED that 50% of the cost of the accounting work, $1,280, should be disallowed.

The ED also contends that $9,106 of the claimed legal fees should be disallowed because they were for legal work on the Utility's previous rate case [113] The ALJ agrees with the ED's substantive argument but cannot find evidence to support the $9,106 amount that the ED cites. The Protestants' witness, Mr. Fenner, agreed with the Utility that the legal work for the prior rate case cost $7,588, but he agreed with the ED that it should not be recovered at all.[114]

The Applicant does not dispute that some of the legal fees during the test year were for work on a previous rate case, which it refers to as the "pass through case." However, its witness, Mr. Raushcuber, testified that those fees, which he calculated as $7,588, should be "straight lined" for five years. [115] He apparently meant they should be amortized and recovered only once rather than being built into the Utility's rates indefinitely. Mr. Raushcuber also rounded off the $7,588 and recommended allowing the Utility to recover $1,520 for five years.

---

[111] Tr. 532-35.

[112] Applicant Ex. 4 at Schedule S tab at last page.

[113] ED Ex. 1 at 12-13 & EP-6 at 1.

[114] AGX Ex. B at 7.

[115] Applicant Ex. 20 at 27.

The ALJ agrees with the ED and the Protestants that expenses for a prior rate case for which the Commission approved a settlement should not be recoverable in a subsequent rate case unless the settlement specifically provided for that possibility. To do otherwise would undermine the implied understanding of the parties that the settlement resolved all related issues. It would also be a collateral attack on the order approving the settlement. On at least two prior occasions, the Commission has denied attempts to recover rate case expenses in later rate cases.[116] The ALJ concludes that the $1,520 for five years should be disallowed.

Mr. Fenner also testified that $6,612 of the $9,330 in routine legal fees was for a one-time expense related to a transmission line improvement. To allow a one-time recovery of that $6,612, Mr. Fenner recommended disallowing the $6,612 but allowing an amortization charge of $1,322 per year for five years.[117] Although no other party recommends that change, the references in the documentation to that construction[118] support Mr. Fenner's recommendation. The ALJ agrees with Mr. Fenner that these legal fees for a one-time project should not be recovered indefinitely each year. The ALJ recommends the amortization treatment suggested by Mr. Fenner.

To summarize: from the $13,380 that the Applicant seeks for professional fees, the ALJ recommends that the Commission disallow $1,280 (accounting fees allocable to the Land Company), disallow $1,520 ($7,588 in legal fees for a prior settled case amortized over five years), disallow $6,612 (non-recurring legal fees related to transmission line), and add a $1,322 per year charge for five years (to recover the non-recurring legal fees related to the transmission line).

---

[116] *AN ORDER Approving the Applications of North Orange Water & Sewer, L.L.C., to Change Water and Sewer Rates*; TCEQ Docket No. 2003-0597-UCR; SOAH Docket No. 582-03-3827 (Dec. 20, 2004)(Finding of Fact No. 27). See also PFD at 13-14. *AN ORDER Setting Retail Water Rates for Waterco, Inc., under Certificate of Convenience and Necessity No. 10130 in Trinity and Walker Counties, Texas*; TCEQ Docket No. 2004-0630-UCR; SOAH Docket No. 582-04-6463 (Jan. 12, 2006)(Finding of Fact No. 13, Conclusions of Law No. 11, and Ordering Provision No. 3, which do not included expenses for prior case). Also see PFD at 13-14.

[117] AGX Ex. B at 7.

[118] Applicant Ex. 4 at Schedule S tab at 9-20 (unnumbered).

V. Lease for the Pre-1985 Assets

On March 1, 2005, the Utility and its affiliated Land Company entered into a surface and facilities lease agreement (Lease).[119] It gave the Utility the right to use certain assets[120] that were constructed before July 1985 (Pre-1985 Assets). The rent stated in the Lease was $1,125 per month for the first year, and the Lease included a rent adjustment clause for subsequent years.

The Applicant seeks to include an annual amount of $13,500 in cost of service for the Lease. The other parties contend that no amount should be included in cost of service for the lease of the Pre-1985 Assets. The ALJ agrees that the entire $13,500 should be disallowed.

At one time, the Land Company held the CCN that the Utility now holds, used the Pre-1985 Assets to provide water service then, and still owns those assets.[121] On July 15, 2005, the Commission approved the transfer of the CCN from the Land Company to the Utility (CCN Transfer Order).[122]

The Utility originally claimed that the Pre-1985 Assets should be included in its rate base. That would have entitled it to recover a return on the assets through rates. In his testimony on behalf of the Utility, Mr. Raushcuber removed the Pre-1985 Assets from the claimed rate base. He testified that the $13,500 lease expense should instead be included in cost of service.[123]

The Utility argues that the CCN Transfer Order approved the Lease of the Pre-1985 Assets. The ED disagrees. Reading the CCN Transfer Order as a whole, the ALJ concludes that

---

[119] Applicant Ex. 11.

[120] Applicant Ex. 4 at Spreadsheet tab at Schedule V at 24 & Schedule CC.

[121] Applicant Ex. 11.

[122] ED Ex. 2 at BDD-12.

[123] Applicant Ex. 20 at 34.

it neither generally authorized the Utility to lease facilities and lines from the Land Company nor approved the specific March 1, 2005, Lease.

The CCN Transfer Order refers to the Utility as having applied for approval to both lease facilities and transfer the CCN from the Land Company. It states, ". . . the application is granted . . ." However, it also states, "Certificate of Convenience and Necessity No. 11241 [is] transferred in accordance with the terms and conditions set forth in the certificate."[124] The certificate makes no reference to the Lease. Instead, it says, "[The Land Company's] facilities and lines were transferred to [the Utility] (CCN No. 11241) in Hays and Travis Counties."[125]

The Utility points to a memo that members of the ED's staff sent to the ED recommending approval of the application to transfer the CCN. In the memo, the Staff refers to the application as one to "lease facilities and the transfer the [CCN]."[126] Based on that the Applicant argues that the ED should be estopped from now claiming that that the lease was not approved. The ED does not agree, contending that estoppel does not run against the state.

The ALJ is not persuaded by the Utility's estoppel argument. The staff memo was sent *to* the ED not *from* the ED; hence, the ED cannot be estopped based on a statement he never made. Nor does the ALJ agree that the staff memo recommended approval of the Lease. The memo only refers in passing to the Utility having applied to "lease facilities" and it does not specifically refer to the March 1, 2005, Lease that is at issue in this case.

It is sufficiently clear that the CCN Transfer Order did not authorize the Utility to lease facilities from the Land Company; approve the March 1, 2005 Lease; or find that the payments under that lease were just and reasonable and appropriate affiliate transactions. Instead, the CNN

---

[124] ED Ex. 2 at BDD-12 at 3 (unnumbered).

[125] ED Ex. 2 at BDD-12 at 4 (unnumbered).

[126] Applicant Ex. 26.

transfer certificate at least contemplated, and arguably ordered, the Land Company to transfer its lines and facilities to the Utility.

That does not necessarily mean that the Lease amount should be disallowed. Instead, the Utility must show that it was a reasonable cost of service and an appropriate affiliate transaction. It did not make that showing.

On October 4, 1985, the Land Company still held the CCN and filed a rate change application with the Commission.[127] On April 15, 1986, the Commission issued an order approving that application in part and denying it in part.[128] In its order, the Commission determined the original costs of certain assets, including the Pre-1985 Assets. Those are set out below and compared to the Applicant's current projection of the original cost of those assets:

Asset	**Original Costs 1986 Order**[129]	**Applicant's Projected Cost**[130]
Well	$16,523.58	$17,700
100,000-gallon storage tank	$35,000[131]	$35,000
Distribution system	$120,170	$164,582
Office furniture and equipment	$253	$0
TOTAL	$171,946.58	$217,282

In the 1986 Order, the Commission also found that:

---

[127] Actually, the Commission's predecessor agency. To simplify writing, the ALJ will refer to all of the predecessor agencies as the Commission.

[128] ED Ex. 2 at BDD-10.

[129] ED Ex. 2 at BDD-10 at 3.

[130] Applicant Ex. 4 a Spreadsheet tab at Schedule V.

[131] This number is derived from the Examiner's Report on which the Commission relied.

- only 50% of the distribution system, or $60,085, was used and useful;
- $3,000 of the 100,000-gallon tank's cost was unreasonable;
- customers had contributed $105,560, which had to be deducted from rate base; and
- $7,988 in deprecation had accumulated.

After make those deductions, the Commission found that the Land Company had only $18,882 in net plant that was used and useful to provide service. The Commission also found that the depreciation expense was $3,092.[132] Relying on that 1986 Order, the ED and the Protestants argue that the subsequent accumulation of depreciation left no net capital from those Pre-July 1985 assets after 6.16 years.[133] The ALJ agrees with that analysis as to the assets found used and useful in the 1986 Order.

The doctrine of collateral estoppel or issue preclusion applies in administrative law cases and precludes the relitigation of identical issues of fact that have been actually litigated between the same parties or those in privity with the original parties.[134] Those in privity with a party may include persons who exert control over the action, persons whose interests are represented by the party, or successors in interest to the party.[135] The ALJ finds that within the context of this case, the affiliated Utility and Land Company are in privity with one another. Thus, the doctrine of collateral estoppel applies and bars the relitigation of the Commission's determinations in the 1986 Order concerning the Pre-1985 Assets.

The Applicant argues that circumstances have changed and the entire distribution system is now used and useful, though the 1986 Order found it was not. That would mean that the other

---

[132] ED Ex. 2 at BDD-10 at FOF 13, 14, 16, 17, 18, 19, 22-25 & 36. The deductions described above total $176,633. The Commission's order either contains a math error, the Commission found that additional plant was in service that was not described in the Order, or the Examiner missed those additional items.

[133] $18882/$3,092=6.1. *See* ED Ex. 2 at 12 and AGX Ex. B at 8.

[134] *Coalition of Cities for Affordable Util. Rates v. Public Util. Comm'n*, 798 S.W.2d 560, 564-65 (Tex. 1990).

[135] *Dairyland County Mutual Ins. Co. of Texas v. Childress*, 650 S.W.2d 770, 773-74 (Tex. 1983).

50% of the distribution system assets, with an original cost of $60,085, are now used and useful. Additionally, the Applicant contends that electric and control facilities with a projected original cost of $2,000 and a hydropneumatic tank with a projected original cost of $12,600 are now used and useful.[136] No party specifically disputes those points. The ALJ agrees with the Applicant and find that these additional Pre-1985 Assets, with an original cost of $74,685, are used and useful.

Of course, that $74,685 in additional assets has also accumulated depreciation since they were put into use. The ED did not prepare a depreciation schedule for those additional assets because Mr. Dickey concluded that they were fully depreciated in accordance with the 1986 Order.[137] Mr. Raushcuber originally prepared a depreciation schedule, but later voided it.[138] Even without an accurate depreciation calculation for the other half of the distribution system and the other Pre-1985 Assets, the ALJ can conclude that the annual payment of $13,500 to lease those assets is a not a reasonable expense.

As discussed later in the PFD, the ALJ concludes that the Applicant's reasonable rate of return on invested capital is 6.0%. If the Pre-1985 Assets had been transferred to the Utility, as the Commission at least arguably ordered, the Utility would only be entitled to a 6.0% return on their depreciated value. It is clear that an annual lease payment of $13,500 for use of the additional Pre-1985 Assets, with an original cost of $74,685, would give the Land Company at least a 23% annual return on those assets. Once depreciation was subtracted from the original costs of those assets, the return would be even higher. The ALJ concludes that it was not a reasonable expense for the Utility to pay $13,500 to its affiliated Land Company to lease the Pre-1985 Assets.

---

[136] Applicant Ex. 4, Spreadsheet tab at Schedule V.

[137] ED Ex. 2 at BDD-2 at 1-2.

[138] Applicant Ex. 4 at Spreadsheet tab at Schedule V & Ex. 13 at Spreadsheet tab at Schedule V.

Should some lesser amount be allowed as a reasonable expense for the lease of the Pre-1985 Assets from Land Company? The ALJ cannot conclude that. The Applicant has the burden of proof and that burden is particularly heavy when an affiliated transaction is involved, like the Lease with the Land Company. The Applicant did not make an alternative argument showing that some amount less than $13,500 would be reasonable and an appropriate affiliate transaction. The ALJ concludes that the entire Lease payment amount of $13,500 should be disallowed.

W. Working Cash Allowance

There is no dispute that the Utility should be allowed a working cash allowance equal to one-eighth of its total annual operations and maintenance expense excluding amounts charged to operations and maintenance expense for materials, supplies, and prepayments (operations and maintenance expense does not include depreciation, other taxes, or federal income taxes).[139] The ALJ asks the ED to provide a recalculation of the working cash allowance that reflects the ALJ's recommendations.

IX. RETURN ON INVESTMENT

Under 30 TAC § 291.31(c)(1), the return on invested capital is the rate of return times invested capital. The Applicant seeks a total return on investment of $111,910.[140] The ED recommends $55,473.[141] The Protestants recommend $52,696.[142] These numbers result from several factors, including the net amount of the Utility's invested capital, the amount of that capital that customers contributed, the Utility's costs of equity and debt, and the percentages of the Utility's capital coming from equity and debt (capital structure).

---

[139] Tr. 513. *See* 20 TAC § 291.31(c)(2)(B)(iii).

[140] Applicant Ex. 20 at 34.

[141] ED Ex. 1 at 17-18 & EP-2.

[142] AGX Ex. C.

The ALJ agrees with the ED's determination concerning the amount of the Utility's used and useful invested capital. He also agrees with the ED concerning customer contribution which must be deducted from invested capital before calculating the return to which the Applicant is entitled. However, the ALJ agrees with none of the parties' recommended rate of return on invested capital. Instead, the ALJ concludes that the reasonable return on the Utility's investment is 6.0%. He asks the ED to recalculate the return in accordance with the ALJ's recommendation and to provide those recalculations with his exceptions.

A. Invested Capital

Utility rates shall be based on the original cost of property used by and useful to the utility in providing service, including if necessary to the financial integrity of the utility, construction work in progress at cost as recorded on the books of the utility. Original cost is the actual money cost or the actual money value of any consideration paid, other than money, of the property at the time it shall have been dedicated to public use, whether by the utility that is the present owner or by a predecessor, less depreciation. Utility property funded by explicit customer agreements or customer contributions in aid of construction such as surcharges may not be included in invested capital.[143]

1. Assets Owned by Others Not Included

Unusually in this case, the Utility includes assets owned by one of its affiliates in its invested capital and argues that it is entitled to a return on those assets. The ALJ concludes that the Applicant is not entitled to include assets owned by others in its invested capital.

As already discussed, the Utility originally claimed that it was entitled to recover through rates a return on the Pre-1985 Assets owned by and leased from its affiliated Land Company. It

[143] Water Code § 13.185(b).

later dropped that claim and instead seeks to include as an expense the $13,500 that it pays to the Land Company annually to lease those assets.[144] As already discussed, the ALJ concludes that the entire Lease payment should be disallowed.

The Applicant still claims that it is entitled to earn a return on $2.71 million in assets that Mr. Hammett personally owns (Hammett Assets) and has pledged as collateral for a $1.6 million loan from Frost Bank to the Applicant.[145] These include two of Mr. Hammett's brokerage accounts with Frost Brokerage Services, his shares in the Land Company, and certain real estate lots at the Land Company's development.[146] The ALJ agrees with the other parties that the Utility is not legally entitled to include the Hammett Assets in its rate base or to obtain a return on them through rates.

The Applicant points to a portion of Water Code § 13.183(a)(1) and argues that rates must allow an "investor" to earn a return on the investor's capital. That is not quite correct. The argument quotes only a portion of that statute and incorrectly substitutes the word investor for "utility." Water Code § 13.183(a) actually reads:

> In setting the rates for water service, the Commission must fix a utility's overall revenues at a level that will:
>
> (1) permit *the utility a reasonable opportunity to earn a reasonable return on its invested capital used and useful in rendering service* to the public over and above its reasonable and necessary operating expenses; and
>
> (2) preserve the financial integrity of the utility.[147] (Emphasis added.)

---

[144] Applicant Ex. Ex. 20 at 34.

[145] Applicant Exs. 33 & 34.

[146] Tr. 423-31.

[147] TEX. WATER CODE ANN. (Water Code) § 13.183(a).

Thus, rates must allow a *utility* to recover a reasonable return on *its* assets, not on assets owned by one of its affiliates or any one else. Commission rule 30 TAC § 291.32(a) paraphrases Water Code § 13.183(a) on this point. Additionally, Commission rule 30 TAC § 291.31(c)(2) lists the components to be included in invested capital, also known as rate base. In doing so, the rule makes the same point. The rate-base components listed in the rule include the "original cost, less accumulated depreciation, of *utility* plant, property, and equipment used by and useful to the utility in providing service." (Emphasis added.) Working capital is also a rate base component, but assets of another do not fall into that category either. The ALJ concludes that assets owned by another entity are not "utility plant property, and equipment" and may not be included in rate base.

The Applicant's own witness, Mr. Raushcuber, has been involved in water rate proceeding for 38 years and has testified as an expert in 12 contested case hearings concerning water rates. He has never seen a case in which a return was granted on assets not owned by the utility.[148]

Despite those laws and Mr. Raushcuber experience, the Applicant contends that an AWWA manual concerning rate setting[149] states that rate base should included the "capital supplied by the investor." The ALJ cannot find that quote in the AWWA manual. Moreover, the portion of the AWWA manual in evidence concerns the determination of a proper *rate of return* on a utility's investment, not the determination of the amount of capital invested.

The Commission's rules state that the return, among other factors, should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to

---

[148] Tr. 666.

[149] Applicant Ex. 35 at 38.

raise the money necessary for the proper discharge of its public duties.[150] One could paraphrase that consideration by saying that the rate of return on a utility's invested capital should be sufficient to reasonably compensate investors and creditors. That does not mean that investors should also receive a return on their separate assets, which were never paid in as capital of the Utility.

The Utility argues that Mr. Hammett's assets, though not equity paid into the Utility, were invested in the Utility because Mr. Hammett pledged them as collateral for a bank loan to the Utility, which used the loan proceeds to invest in new plant facilities. The ALJ does not agree.

If the loan proceeds were used by the Utility to purchase new plant assets that are currently used and useful in providing service, the Utility would be entitled to earn a return through rates on those new plant assets. That return would then be available to pay the interest on the loan as well as to compensate the equity investor, Mr. Hammett. By asking to also include Mr. Hammett's pledged assets in invested capital, the Utility is asking, in effect, for a double return on those used and useful plant assets.

Moreover, as discussed later, the Utility's debt exceeds the value of the Utility's used and useful physical assets. To the extent of that exceedance, Mr. Hammett's pledged assets are in no way related to the Utility's current ability to provide service. The ALJ concludes that Water Code § 13.183(a) and 30 TAC §§ 291.31(c)(2) and 291.32(a) do not permit the inclusion of Mr. Hammett's pledged assets in the Applicant's invested capital.

---

[150] 30 TAC § 291.31(c)(1)(A).

2. Assets Owned by the Utility

The Applicant claims that it also has used and useful assets that were constructed after June 2000, which it refers to an "in-plant assets."[151] It argues that their original cost was $1,325,069. There is no dispute that the Applicant owns these assets.

However, the ED argues that certain adjustments should be made, which reduces the original cost of the in plant assets to $1,043,135. After deducting accumulated depreciation, the ED calculates that their net value is $1,038,240.[152] The Protestants' witness, Mr. Fenner, initially offered an analysis of invested capital that was slightly different from the ED's. He later adopted the ED's rate base, except to disagree with the ED's recommendation to a put a portion of the net plant value of a truck into rate base.[153]

For the reasons set out below, the ALJ agrees with and recommends adoption of the ED's adjustments. The ALJ concludes that the original cost of the Utility's in-plant assets that are used and useful to provide service is $1,043,135. After deducting accumulated depreciation, the net plant is $1,038,240.

a. New Ground-Storage Water Tank

The ED argues that $78,945.78 should be disallowed from the original cost of a new 109,500-gallon, ground-storage water tank (New Tank). He claims that 88% of that tank is not used or useful to provide service; hence, 88% of the tank's value, or $78,945.78, should be disallowed. The Applicant argues that the New Tank is used and useful and no disallowance is warranted. The ALJ agrees with the ED's proposed disallowance.

---

[151] Applicant Ex. 4 at Spreadsheet tab at Schedule U & Ex. 20 at 32.

[152] ED Ex. 2 at 14.

[153] Tr. 301-03.

In addition to the New Tank, the Utility still uses a 100,000-gallon ground storage tank that was built before July 1985 (Old Tank). The Old Tank is one of the Pre-1985 Assets that is owned by the Land Company and Leased by the Utility.

Under 30 TAC § 290.45(b)(2)(E), a utility must have a storage capacity of 200 gallons per connection. Mr. Dickey testified that the Utility had 367 connections at the end of the test year and that two areas that it will serve in the future have 131 and 67 lots. To serve the total 565 connections will eventually require 113,000 gallons of ground storage capacity, 13,000 more than the Old Tank provides. Based on that, Mr. Dickey reasoned that only 13,000 gallons, or 12%, of the New Tank's capacity was used and useful to provide service and that the remaining 88% was not. That led him to recommend disallowing 88%, or $78,945.78, of the original cost of the New Tank.[154]

The Utility argues that Mr. Dickey later admitted that its water system, including the New Tank, was not overbuilt and had capacity to serve only a few more than the existing customers. The cited testimony does not support that argument. Mr. Dickey agreed to a series of mathematical calculations by the Applicant's counsel. At one point, he agreed that there was only a surplus of 23,000 gallons, but from the context it is clear that he was only agreeing that the difference between 200,000 gallons and 177,120 gallons is approximately 23,000 gallons.[155] Mr. Dickey never retracted his testimony that 88% of the New Tank was not used and useful.

The Applicant also contends that the Mr. Dickey is unqualified to offer an expert opinion on the use and usefulness of the New Tank. It asserts that one must be a licensed professional engineer to have an opinion on whether assets are used and useful to provide service, to apply

---

[154] ED Ex. 2 at 14-16.

[155] Tr. 584-86.

mathematics, and even to apply the Commission's related rules.[156] The ALJ does not agree, and apparently neither does one of the Applicant's own professional engineers.

It is true that Mr. Dickey is not a licensed professional engineer, though he received a degree in mechanical engineering.[157] He is an expert in water rate design, especially the portions related to engineering and technical criteria set out in the Commission's rules. He has worked for the Commission on those issues since 1999.[158]

The Texas Engineering Practice Act defines the "practice of engineering" as "the performance of or an offer or attempt to perform any public or private service or creative work, the adequate performance of which requires engineering education, training, and experience in applying *special knowledge or judgment* of the mathematical, physical, or engineering sciences to that service or creative work."[159] (Emphasis added.) The Act also gives a number of examples of the practice of engineering, but does not include applying state rules or determining whether a utility's assets are used and useful for rate setting. Instead, the examples focus on design, planning, and giving opinions for design, construction, engineering uses, planning, surveying, etc.

Richard Wheeler is a credible, expert professional engineering witness. He testified on behalf of the Applicant. No party questions his professional engineering expertise or his opinion that the New Tank meets professional engineering standards. Yet Mr. Wheeler was not familiar with the term "used and useful" and admitted that he was not a rate design specialist.[160] If a licensed and very experienced professional engineer with a long history of designing and

---

[156] Tr. 547-54.

[157] ED Ex. 2 at 1; Tr. 547.

[158] ED Ex. 2 at 1-2.

[159] Occupations Code § 1001.003(b).

[160] Tr. 36-37.

planning water resource and water utility projects,[161] like Mr. Wheeler, has no knowledge or expertise in the determining whether assets are used and useful for water utility rate design purposes, the ALJ cannot see how that is an area of "special knowledge or judgment" that only professional engineers have.

That certainly does not mean that engineering is wholly irrelevant to determining whether assets are used and useful for setting rates. A water storage tank that did not comply with engineering standards and needed to be replaced might not be used and useful to provide water service. On the other hand, a properly engineered storage tank that was being used might not be useful if it was larger than the Commission's rules require. Mr. Dickey was qualified to provide an expert opinion on that second point and did not need to be a registered professional engineer to give his opinion.

Applying the 200-gallons per connection requirement of section 290.45(b)(2)(E) would mean that the Utility only needed 73,400 gallons of storage capacity to serve the 367 customers at the end of test year. There is some evidence that the Utility had 402 connections in May 2010, when the hearing was held.[162] Assuming that a post-test year adjustment was in order for that, the Utility would need 80,800 gallons of storage capacity. Mr. Wheeler indicated that the 209,500 gallons of storage capacity in the Old and New Tanks combined could only serve 415 connections, but applying the Commission's 200-gallons per connection minimum requirement would indicate that only 83,000 gallons of storage was required to serve 415 connections. The 100,000-gallon tank that was built before July 1985 could easily supply those required storage capacities. That suggests that no portion of the new 109,500-gallon storage tank is necessary to provide service.

---

[161] Applicant Ex. 17 at 4-5.

[162] Tr. 637.

Yet Mr. Dickey's proposed disallowance is premised on an even larger post-test year adjustment in the number of customers. He assumes a 200-gallon capacity is needed for each current lot in the CCN, whether it currently has a connection or not. That raises the number of connections to 565 and the necessary and useful storage capacity to 113,000 gallons, making 13,000 gallons, or 12%, of the New Tank's capacity used and useful. This strikes the ALJ as an extremely generous post-test year adjustment, but no party argues that a lower percentage of the New Tank's cost should be included in rate base.[163] Based on Mr. Dickey's testimony, the ALJ concludes that at least 1,300 gallons, or 12%, of the New Tank's capacity is used and useful.

There is some legal room to argue that even more storage capacity is used and useful. Commission rule 30 TAC § 290.45, which includes the 200 gallons per connection storage requirement, states that all of its capacity requirements are only minimums.[164] It states that greater capacity may be required if a normal operating pressure of 35 psi, or 20 psi during unusual conditions, cannot be maintained.[165] It also allows for alternative capacity requirements, in lieu of the required minimums, upon a detailed showing that is approved by the ED, though that seems to contemplate the approval of lower capacities than otherwise required instead of higher ones.[166]

In effect, the Applicant is arguing that 2.4 times the required 200 gallons of storage per connection is necessary. It offered no evidence to show that the additional capacity is necessary to maintain a pressure of 35 psi, or 20 psi in unusual conditions, at each connection counted at the end of the test year or even the Utility's known and measurable number of connections after

---

[163] The Protestants' witness, Mr. Fenner, initially recommended allowing only the portion of this and other plant in service items necessary to serve the 367 connections at the end of the test year. AGX Ex. B at 9. However, he later modified that recommendation and adopted Mr. Dickey's rate base recommendation. Tr. 301-03.

[164] 30 TAC § 290.45(a)(1).

[165] 30 TAC § 290.45(a)(2).

[166] 30 TAC § 290.45(g).

the test year. Nor did the Applicant show that 2.4 times the required storage capacity had been approved by the ED or that it had even applied for such approval.

Instead, the Applicant argues that a larger storage capacity is needed based on an LCRA design criterion of 1.3 gpm per connection per max day.[167] Mr. Wheeler testified that under their contract LCRA is required to supply the Utility with a flow of 400 gpm.[168] He also stated that the Utility could provide an additional 139 gpm of flow using both of its ground storage tanks.[169] Using the LCRA's 1.3 gpm per connection for max day criterion, Mr. Wheeler testified that the combined 539-gpm flow from LCRA plus the Old and New Tanks was sufficient for only 415 connections, just 32 more than he testified that the Utility had at the end of the test year.[170] Based on that, the Applicant argues that all of the capacity of the New Tank is used and useful. The ALJ did not find that argument persuasive.

The Applicant does not cite a provision of its contract with LCRA or any other evidentiary document that either mandates or suggests the use of a 1.3 gpm standard. The ALJ has no reason to doubt Mr. Wheeler's testimony that some kind of 1.3 gpm LCRA criterion exists. Why, however, would it apply in this context? It is not a storage criterion, like gallons per connection, but a rate of flow criterion, stated in gallons per minute. The ALJ can understand how stored water could be tapped, until exhausted, to provide more flow than the LCRA line alone would provide. But Mr. Wheeler did not explain why nor is there evidence explaining why the LCRA's 1.3 gpm criterion should apply in this context.

---

[167] Mr. Wheeler stated that the max day is not the estimated annual peak day of demand but an average of several days, but he could not remember the exact ratios that led to the determination of max day. Tr. 27-28.

[168] Tr. 28; Applicant Ex. 9 at 4.

[169] Tr. 26-32. Mr. Wheeler apparently rounded off the 209,500-gallon total capacity of both tanks to 200,000 and divided that by the 1,440 minutes in a day to derive the 139-gpm figure.

[170] Tr. 31. Other evidence from the Applicant indicates that it had 367 connections at the end of the test year. Applicant Ex. 4 at Spreadsheets tab 30 & 20 at 15.

As the ED notes, there is a Commission rule that requires a 0.6 gpm per connection minimum flow rate for a plant relying on surface water.[171] That is less than half of the 1.3 gpm rate that the Applicant claims is necessary. Mr. Wheeler had no knowledge of the Applicant ever applying to the ED for approval of a higher flow rate than the required 0.6 gpm per connection.[172]

Instead, letters from another professional engineer with Mr. Wheeler's firm, R.A. Miller, to the ED repeatedly indicated that the LCRA line supplemented with the storage from the Old and New Tanks "will supply the required 0.6 gpm per connection."[173] Mr. Miller also wrote that the New Tank and other improvements "will supply the required 0.6 gpm," which "will provide water service for up to 666 connections."[174] The Applicant claims that Mr. Wheeler affirmed that the system was insufficient to serve 666 connections, but the transcript citation that the Applicant gives does not support that claim. Instead, Mr. Wheeler agreed that the system was *not* insufficient to provide water service to 666 customers at 0.6 gpm.[175] Given this evidence, the ALJ cannot conclude that Mr. Wheeler had a reasonable basis for his testimony that a 1.3 gpm flow was required to serve 415 connections.

The Applicant also argues that the New Tank is used and useful because the LCRA contract requires a physical separation (air gap) between LCRA's wholesale water supply and the Applicant's retail water supply. An air gap prevents backflow of water to the LCRA.[176] Mr. Wheeler testified that the air gap was required to comply with the LCRA contract and that providing the air gap was the "primary function" of the New Tank. The air gap is located just

---

[171] 30 TAC § 290.45(b)(2).

[172] Tr. 26.

[173] ED Ex. 2 at BDD-4 at 2-3 & AGX Ex. B at BWF-8 at 2.

[174] AGX Ex. B at BWF-8 at 2, 4 & 5; Tr. 32-35.

[175] Tr. 35.

[176] Tr. 625-26.

before the New Tank where the transmission main delivers water from LCRA. There is no air gap at the site of the Old Tank.[177]

Mr. Raushcuber explained how the New Tank provides the air gap. Water from LCRA is piped to the top of the tank and allowed to fall to the bottom, so the empty upper portion of the tank space is the physical separation between the LRCA inflow and the Utility's water at the bottom of the tank.[178] Mr. Raushcuber explained that the Old and New Tanks were approximately one mile apart. The air gap could not be placed near the Old Tank because the Utility's internal plumbing would have to be used to pump water there, thus the Utility's system would not be physically separated from LCRA's.[179]

No party questions that an air gap is necessary, the New Tank provides the required air gap, or the air gap is placed in a proper location. However, the ED argues that a New Tank was not required to provide the air gap. If so, that might mean the cost of the New Tank was not reasonably necessary to provide an air gap. In fact, the Applicant's witness, Mr. Wheeler, testified that a 50,000-gallon tank could have been used to supply existing customers,[180] which shows that there was at least one other option for provision of the air gap.

The ALJ concludes that the proposed disallowance of $78,945.78, 88% of the original cost, of the New Tank is appropriate because the Applicant failed to show that it is fully useful and a necessary and reasonable expense. While the New Tank is used, the weight of the evidence does not show that any portion of the New Tank's volume is necessary and useful to store water to serve the Utility's 367 end-of-test-year customers. The Old Tank's 100,000-gallon volume would have provided significantly more than the 73,400 gallons of storage necessary to achieve the required 200 gallons per connection. In fact, the Old Tank could serve the 402

[177] Tr. 26-27.

[178] Tr. 625-26; Applicant Ex. 41 at 2-3.

[179] Tr. 625-27.

[180] Tr. 30.

connections in March 2010, since only 80,400 gallons of storage was required for them. Whether the New Tank was necessary and reasonable to provide an air gap is a closer question. It is clear that an air gap is necessary and the New Tank provides that, but there was at least one other option that might have cost less and the Applicant did not address that issue. It is insufficiently clear from the evidence that the full $89,711.11 original cost of the New Tank would have been a reasonable cost if incurred solely to provide an air gap.

The ED's recommendation assumes that storage capacity is necessary to serve 565 connections, which is 198 more than at the end of the test year and includes 163 lots that currently have no connection. That is a very large 54% increase in the number of end of test year connections and a 41% increase in the number of connections for which there is any specific evidence. The ALJ finds that this very generous post-test year adjustment, which allows 12% of the New Tank's capacity to be deemed used and useful, is adequate to compensate the Utility for both the storage capacity and the air gap provided by the New Tank. The ALJ concludes that the remaining $78,945.78 original cost of the New Tank should be disallowed.

b. Plugging of South and North Wells

The ED proposes disallowances of $1,794.33, that the Utility spent to plug its South well, and $2,116.83, spent to plug the North well. The ALJ agrees with those disallowances.

The ED's witness, Mr. Dickey, testified that both wells have been fully depreciated; hence, they are no longer used and useful to provide service and further expenses related to them should be disallowed. [181] Without going into detail, Mr. Fenner agreed that expenses for wells and other assets that are no longer used and useful should be disallowed.[182]

---

[181] ED Ex. 2 at 16

[182] AGX Ex. B at 9.

The Applicant argues that Mr. Dickey later admitted that well expenses he initially proposed to delete were for wells still used for an emergency water supply. It is not clear that the Applicant intended to apply this argument to the plugging expenses. Logically, a plugged well can no longer be used for a backup water supply. Mr. Dickey testified that another well was used for emergency water, and he proposed no disallowance for the expense of its pump.[183]

The ALJ cannot agree that the plugging expenses should be included in rate base. From a water service perspective, a plug has no ongoing useful life. Perhaps plugging expenses incurred during a test year should be allowed as operating expenses and amortized since they do not recur for the same well. However, the plugging expenses for the North and South wells were incurred on June 29 and 30, 2005,[184] which was well before the test year. Given all the above, the ALJ agrees with the ED that the expenses of plugging the North and South wells should be disallowed.

c. Well Pumps

Mr. Dickey also proposed to disallow $4,282.41 for a well pump put in service on June 9, 2000, and $12,208.34 for a well pump put in service on August 18, 2003. He testified that they were no longer in service and had been removed.[185] The ALJ agrees that these amounts should be disallowed.

The Applicant cites no evidence to show the pumps are still in service, other than to argue that Mr. Dickey later admitted that they were. In fact, Mr. Dickey made no such

---

[183] Tr. 580-81.

[184] ED Ex. 2 at BDD-2 at 2-3.

[185] ED Ex. 2 at 16 &

admission. Instead, he testified that another well was used for emergency water, and he proposed no disallow for that well's pump.[186]

d. Fire Hydrants

The ED proposes to disallow $23,800 paid to install seven fire hydrants.[187] That is appropriate, since fire protection is not retail water service. The Applicant offers no argument to the contrary. The ALJ recommends the proposed disallowance.

e. Truck

As discussed elsewhere in the PFD, the ALJ recommends allowing no portion of the cost of the 2006 F150 truck as an operating expense. He instead recommends capitalizing the $15,078 remaining net value of the truck, with a service life of 20 years, which will yield a return on that value and an additional annual depreciation of $850.

3. Invested Capital Reduction Due To Customer Contribution

As of April 30, 2009, the Utility's customers had paid $167,781 under a surcharge adopted in settlement of a rate case in 2005. From May 2006 through March 2008, the Applicant paid $118,812 for hauled water from vendors other than LCRA. The Utility does not propose to include those hauled water expenses in its cost of service or to create another surcharge to recover it. Instead, it contends that the hauled water expenses have reduced the surcharge collections to $48,968, which should be credited as a customer contribution to invested capital.

---

[186] Tr. 580-81.

[187] ED Ex. 2 at 17.

The other parties disagree with this approach. First, as previously discussed, they would have objected if the Utility had included the $118,812 for hauled water in its cost of service. More importantly, they contend that the entire $167,781 paid under the 2005 surcharge was a capital contribution that reduced the Utility's invested capital. The ALJ agrees with the other parties on this point.

In 2005, the Utility, several of its customers, the ED, and the OPIC entered into an agreement to settle a rate case. That agreement specified:

> The utility shall collect a surcharge of $12.00/month/customer. The utility shall deposit 100% of the collected funds in escrow with Wells Fargo Bank. The Executive Director will review and approve the utility's withdrawal of any funds from the escrow account. The utility will give priority to expenditures for the acquisition of LCRA treated surface water. . . . Surcharge (monthly fee to be collected until March 1, 2010) $12.00. *This fee will be charged each customer on a monthly basis for five years to collect sufficient revenue to pay for improvements to the water system.*[188] (Emphasis added).

The Utility had applied for approval of that surcharge to:

> . . . fund improvements to the water systems to ensure current and future compliance with the requirements of the Texas Commission on Environmental Quality (the "TCEQ"). . . . The surcharge will be $12.25 per month per customer until March 1, 2019. The surcharge will cover approximately $447,615 in expected construction costs.[189]

Those settlement provisions have important consequences. Water Code § 13.183(b) provides:

---

[188] ED Ex. 2 at BDD-5, *Water Rate/Tariff Change Application of Deer Creek Ranch, Inc., Water CCN No. 11241 in Hays and Travis Counties, Application No. 3448-R*, TCEQ Docket No. 2004-0618-UCR, SOAH Docket No. 582-04-6437.

[189] ED Ex. 2 at BDD-6.

> . . . A facility constructed with surcharge funds is considered customer contributed capital or contributions in aid of construction and may not be included in invested capital, and depreciation expense is not allowed.

Additionally, Water Code § 13.185(b) states, ". . . Utility property funded by explicit customer agreements or customer contributions in aid of construction such as surcharges may not be included in invested capital." Further, Commission rule 30 TAC § 291.31(c)(2) provides:

> Invested capital, also referred to as rate base. The rate of return is applied to the rate base. Components to be included in determining the rate base are as follows:
>
> (A) original cost, less accumulated depreciation, of utility plant, property, and equipment used by and useful to the utility in providing service:
> . . .
> (iv) utility property funded by explicit customer agreements or customer contributions in aid of construction such as surcharges may not be included in original cost or invested capital . . .

To justify the Utility's proposed treatment of the surcharge proceeds, Mr. Raushcuber testified that cost of hauled water during the construction of the LCRA interconnect was a capital cost to the system similar to an interest payment during construction.[190] Other than that claim, the Utility offers no rationale for viewing the cost of hauled water as a capital cost. The ED's Mr. Dickey responded that purchased water is not a capital improvement and noted that the Utility had not obtain the ED's approval to use the surcharge collections to pay for purchased water.[191]

The ALJ cannot agree with the Applicant's contention that the cost of purchased water is a capital expense. Purchased water is not a capital improvement that is used and useful over many years; it is instead used nearly immediately after purchase. That is why "Purchased water"

---

[190] Tr. 169 and 223.

[191] ED Ex. 2 at 6.

is included as a cost of service item in the Commission's rate application[192] and not as a capital item in the original inventory of the water utility plant.[193]

The ALJ concludes that that the Utility's invested capital was reduced by the entire $167,781 that the customers paid as a surcharge, not just $48,968 as the Applicant contends.

4. Rate Base Summary

As set out above, the ALJ agrees with all of the ED's adjustments to the Applicant's proposed rate base. Thus, he agrees with the ED that the original cost of the rate base assets is $1,043,135. After deducting accumulated depreciation, the net value is $1,038,240.

B. Return on Investment

Unless the Commission establishes alternate rate methodologies, the Commission may not prescribe any rate that will yield more than a fair return on the invested capital used and useful in rendering service to the public. In fixing a reasonable return on invested capital, the Commission must consider, in addition to other applicable factors, the efforts and achievements of the utility in the conservation of resources, the quality of the utility's services, the efficiency of the utility's operations, and the quality of the utility's management. [194]

Under 30 TAC § 291.31(c)(1), the Commission also fixes the rate of return in accordance with the following additional principles:

---

[192] Applicant Ex. 4 at Application tab at 14 of 42.

[193] Applicant Ex. 4 at Application tab at 10 of 42.

[194] Water Code § 13.184(a) & (b) & 30 TAC § 291.31(c)(1)(B).

> (A) The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.
>
> . . .
>
> (C) The commission may, in addition, consider inflation, deflation, the growth rate of the service area, and the need for the utility to attract new capital. In each case, the commission shall consider the utility's cost of capital, which is the composite of the cost of the various classes of capital used by the utility.

1. Cost of Equity

The Utility claims that the reasonable rate of return on its invested capital is 12.5%. Mr. Raushcuber testified that the Commission has historically used rates of return between 10 and 15%. Based on that, he concluded that 12.5% was an appropriate return.[195]

The ED argues that the Applicant's reasonable rate of return on equity is 7.45%. He concedes that for some applications the Commission has approved a 12% rate of return, but not higher. The ED notes that the Applicant has the burden of proof and claims that the Applicant has not shown that a rate of return on equity higher than 7.45% is reasonable. The other parties agree with the ED. So does the ALJ.

Using the rate of return worksheet included in the Commission's rate change application instructions,[196] Ms. Pascua calculated that the rate of return should be 7.45%. [197] Starting with the most current average return on Baa rated public utility bonds as a base, the worksheet provides for upward adjustments of up to 8.0% for certain systems. Ms. Pascua testified that the average rate of return on Baa public utility bonds for the last 12 months, according to Moody's,

---

[195] Tr. 223.

[196] ED Ex. 3 at 26-27.

[197] ED Ex. 1 at 17-18 & EP-7.

was 7.45%.[198] There is no evidence to contradict her on that point. She concluded that no upward adjustments were warranted, so she recommended a 7.45% rate of return.

The Applicant argues that the Commission staff has proposed a change to the method long used to determine rate of return and that change must be adopted through a rulemaking. The evidence does not show that.

The worksheet is consistent with and applies rate of return principles set out in the Water Code and the current rules.[199] It ensures access to credit and equity markets by starting with the current rate of return on publicly traded bonds. According to Mr. Raushcuber, that reflects debt with zero risk of return.[200] However, the worksheet allows for upward adjustments to reflect systems with higher risks to capital, including systems with small numbers of customers, low growth, unstable populations, and aging facilities. Upward adjustments are also allowed when the Utility's management conserves water resources and provides high quality of service and good management.

The worksheet methodology is consistent with the historical practice. Given the current 7.45% Baa bond rate and the possibility of upward adjustments totaling 8.0%, the calculation methodology set out in the worksheet allows for the possibility of a 15.45% rate of return. That would be consistent with Mr. Raushcuber testimony that he has seen the Commission approve rates of return as high as 15%.

There is no evidence of a rate of return being set lower than 10% in a prior rate case, but nothing in the rules or statues guarantee a minimum 10% return. Moreover, the Applicant, not the ED, has the burden of proof. It has not proven facts that would lead to an upward adjustment

---

[198] ED Ex. 1 at 17-18 & EP-7.

[199] Water Code § 13.184(b) and 30 TAC § 291.31(c)(1).

[200] Tr. 629-30.

on the Commission's worksheet. Nor has it offered a reasonable alternative to the methodology set out in the worksheet. Given that, the ALJ concludes that the 7.45% rate of return on equity recommended by the ED is both reasonable and consistent with applicable law.

2. Cost of Debt

At the end of the test year, the Utility owed Frost Bank $1,596,816 for loans with an annual interest rate of 6.0%.[201] It also had an auto loan of $18,860 at 7.49% interest. According to Ms. Pascua, the total debt of $1,615,676 should be reduced by $9,430, to $1,606,246, to reflect the allocation of 50% of the auto debt to the Utility and 50% to the non-utility.[202] There is no dispute concerning these debt amounts or the interest rates applicable to them.

3. Using a Weighted Cost of Capital Is Not Reasonable In This Case

The ED's Mr. Dickey concluded that the net value of the Utility's used and useful assets was $1,038,240.[203] However, its total debt is $1,606,246.[204] That would mean that the Utility has negative equity: It owes $568,006 more than its currently used and useful assets are worth.[205] The ALJ agrees that the Applicant has negative equity.

Given that, what is the reasonable rate of return on the Utility's assets that are currently used and useful? The Utility obtained a 6.0% bank loan from Frost Bank to borrow $1,596,816, thus the annual interest that it owes is $95,809. The Utility argues that its return should be that amount plus at least a 7.45% return on the personal assets that Mr. Hammett pledged to obtain

---

[201] Applicant Ex. 4 at Spreadsheet tab at Schedule CC; Tr. 178-79.

[202] ED Ex. 1 at 16-17 & ED Ex. 5 at EP-4.

[203] ED Ex. 2 at 14.

[204] ED Ex. 1 at 16-17 & ED Ex. 5 at EP-4.

[205] Ms. Pascua reached a similar conclusion that the Utility had a negative equity was $550,903, but that was based on an earlier lower total invested capital calculation of $1,055,343 by Mr. Dickey. ED Ex. 5 at EP-4.

the loan.[206] The ALJ has already rejected the Applicant's claim that Mr. Hammett's personal assets should be included in the Utility's invested capital. In terms of a return solely on the Utility's own assets, the Utility's argument amounts to a request for a 13.45% return, 6.0% plus 7.45%. The ALJ has not shown that a 13.45% return would be reasonable.

The ALJ recognizes that Mr. Hammett pledged personal funds to secure the loan from Frost Bank, but he sees no basis for inferring a higher cost of borrowing than 6.0% to provide a stream of revenue that the Utility might use to compensate Mr. Hammett. There is no evidence that the Utility agreed to compensate Mr. Hammett for the pledge. Additionally, Mr. Hammett is an affiliate of the Utility, so any such compensation agreement would have been subject to a high degree of scrutiny.

Ms. Pascua testified that when a utility has outstanding debt a weighted cost of capital approach should be used.[207] In its original application, the Applicant's witness, Mr. Raushcuber, included a 5.58% test year weighted cost of capital.[208] In his revised testimony, however, Mr. Raushcuber abandoned that approach and recommended a 12.5% rate of return.[209] The ALJ cannot agree with Mr. Raushcuber's final recommendation, which would apply a higher rate of return than the 7.45% that the evidence shows is the reasonable cost of equity. Worse, it completely ignores that fact that all of the invested capital that the Utility has was funded with debt, mostly with an interest rate of 6.0%.

Using a weighted cost of capital approach and a negative equity amount of $550,903, before Mr. Dickey recalculated it as $568,006, Ms. Pascua concluded that the Utility's weighted cost of capital was 5.2564%.[210] Her calculation table is set out below:

---

[206] Applicant's Closing at 30.

[207] ED Ex. 1 at 18.

[208] Applicant Ex. 4 at Spreadsheet tab at Schedule CC.

[209] Tr. 196-197.

[210] ED Ex. 1 at 17-18 & Ex. 5 at EP-4.

PAYEE	PRINCIPAL	INTEREST RATE	PERCENTAGE OF EQUITY	WEIGHTED AVERAGE
Frost Bank	$1,596,816	6.00%	151.31%	9.08%
Auto Loan	$9,430	7.49%	0.89%	0.07%
Equity	$(550,903)	7.45%	-52.20%	-3.89%
TOTAL	$1,055,343		100%	5.2564%

The ALJ cannot agree that it is reasonable to use a rate of return that is lower than both the Utility's reasonable cost of equity of 7.45% and cost of debt of 6.0%. The ALJ acknowledges that it is normally reasonable to use a weighted cost of capital approach when a utility has financed its used and useful assets partly with equity and partly with debt. For example, imagine a utility with a positive equity of $1 million, a 50-50 capital structure, a reasonable cost of equity of 7.45%, and a reasonable cost of debt of 6.0%. Using Ms. Pascua's weighted cost of capital table and making those changes, the results would be as follows:

PAYEE	PRINCIPAL	INTEREST RATE	PERCENTAGE OF EQUITY	WEIGHTED AVERAGE
Bank Loan	$500,000	6.00%	50%	3.00%
Equity	$500,000	7.45%	50%	3.725%
TOTAL	$1,000,000		100%	6.725%

If this hypothetical utility's rates were set to allow it to receive a 7.45% return on all of its used and useful assets instead of using a weighted average, the utility would actually receive an unreasonably high 8.9% return on its equity. That is because it would receive 7.45% on the portion financed with debt, but only have to pay its creditors 6.0% for that portion. That would leave an extra 1.45% for equity investors (7.45% plus 1.45% equals 8.9%).

For a utility owing more than its used and useful assets are worth, however, using a weighted cost of capital approach is inappropriate. As Ms. Pascua calculated, the weighted rate of return on its used and useful assets would be lower than the reasonable cost of the debt that the Utility used to acquire those assets. It could never repay its debt, which would lead to a financial death spiral.

4. Rate of Return Conclusion

If not a weighted cost of capital approach, then what? In that the net value of the Utility's used and useful assets is $1,038,240 and its loan of $1,596,816 from Frost Bank borrowed at 6.0% interest exceeds that rate base by a large margin, the ALJ concludes that the Utility's entire rate base is funded with that debt and its reasonable rate of return is 6.0%. The ALJ asks the ED to assume a 6.0% return on investment in his recalculations based on the ALJ's other recommendations.

C. Return Conclusion

Because he concludes that the net value of the Utility's used and useful assets is $1,038,240 and its reasonable rate of return in 6.0%, the ALJ concludes that the Utility's reasonable and necessary return on investment is $62,294.

X. ANNUAL DEPRECIATION

Depreciation expense included in the cost of service includes depreciation on all currently used, depreciable utility property owned by the utility except for property provided by explicit customer agreements or funded by customer contributions in aid of construction. Depreciation on all currently used and useful developer or governmental entity contributed property shall be

allowed in the cost of service.[211] Depreciation expense is based on original cost and computed on a straight-line basis over the useful life of the asset as approved by the Commission.[212]

The ED's Ms. Dickey concluded that the Utility's annual depreciation expense was $30,004.[213] The Protestants agree with that recommendation. The Utility's witness, Mr. Raushcuber, recommended an annual depreciation of $36,210.[214] The difference is due to Mr. Dickey's proposed invested capital disallowances.[215] The ALJ agrees with those disallowances; hence, he also agrees with Mr. Dickey's annual depreciation amount of $30,004.

XI. OTHER EXPENSES

A. Federal Income Taxes

Under 30 TAC § 291.31(b)(1)(D), allowable expenses, to the extent they are reasonable and necessary, may include federal income taxes on a normalized basis. Federal income taxes must be computed according to the provisions of Water Code §13.185(f), if applicable.

The Applicant has requested that $9,519 be included in the cost of service for the payment of federal income taxes.[216] The other parties recommend zero for federal income taxes, and the ALJ agrees with their recommendation.

The Applicant argues that it is entitled to a $159,272 return on its invested capital minus customer contribution. That is 12.5% of $1,276,202 in net book value plus $46,944 in working

---

[211] Water Code § 13.185 (j).

[212] 30 TAC § 291.31(b)(1)(B).

[213] ED Ex. 2 at 14.

[214] Applicant Ex. 20 at 34.

[215] ED Ex. 2 at 14-17.

[216] Applicant Ex. 20 at 27-28.

capital minus $48,968 in customer contribution. However, to determine its taxable income, the $95,809 in annual interest that it owes on its Frost Bank loan must be deducted. On that $63,463, it would owe a 15% tax, or $9,519.[217]

The other parties argue, as set out elsewhere in the PFD, that the Utility's reasonable return on investment is much lower. In fact, so low that the Utility will have negative income and owe no federal income tax.[218]

As set out above, the ALJ concluded that the reasonable return is $62,294. That is less than the $95,809 in interest that the Utility owes to Frost Bank. Even without a precise calculation, the ALJ can conclude that the Utility will have negative income and owe no income tax, so its reasonable expense for federal income tax is zero.

B. Rate Case Expense

The Applicant contends that its expenses for this rate case as of the time it filed its application were $27,230.[219] It also claims that it additionally incurred approximately $100,000 in rate case expenses.

The ALJ sustained the Protestants' objection during rebuttal to the Applicant's offering evidence of its claimed additional $100,000 of rate case expenses.[220] That evidence did not rebut any evidence that the other parties had offered during their direct cases. The Applicant showed no good cause to justify its being offered during rebuttal. Additionally, the Applicant had not prefiled the evidence as required for direct case evidence, produced it during discovery, or

---

[217] Applicant Ex. 20

[218] ED Ex. 1 at 16 & EP-5; AGX Ex. B at 10-11.

[219] Applicant Ex. 20 at 29.

[220] Tr. 594-607.

informed the other parties that the evidence would be offered during rebuttal. Thus, the other parties had no opportunity to anticipate its being offered late and to prepare a response.

Nevertheless, the ALJ agreed to recommend that the Commission remand the case to consider those additional rate case expenses if he found that the Utility was entitled to recover any rate case expenses. The Applicant asks that the case be remanded to give it that opportunity to offer additional evidence.

The other parties do not agree that all of the Applicant's rate case expenses were necessary, reasonable, and supported by evidence.[221] But they think that all of the rate case expenses should be disallowed even if the expenses meet those standards. The ALJ agrees that all of the rate case expenses should be disallowed, and he concludes that no remand is necessary to consider the additional $100,00 of claimed expenses.

Commission rules 30 TAC § 291.28 (7) and (8) provide:

> (7) A utility may recover rate case expenses, including attorney fees, incurred as a result of a rate change application only if the expenses are reasonable, necessary, and in the public interest.
>
> (8) A utility may not recover any rate case expenses if the increase in revenue generated by the just and reasonable rate determined by the commission after a contested case hearing is less than 51% of the increase in revenue that would have been generated by a utility's proposed rate.

The Utility applied to increase its revenue by $104,000 per year.[222] Mr. Dickey testified that if the ED's highest recommended rates were adopted it would only increase the Utility's revenue by $10,305.36. That is only a 9.9% increase.[223] Mr. Dickey later revised his highest

---

[221] Tr. 604-605.

[222] Applicant Ex. 4 at Application tab at 34.

[223] ED Ex. 2 at 23-24.

recommended base rate from $37.34 to $38.73,[224] which would make the increase a bit larger than 9.9% if adopted but still far short of 51%.

The ALJ does not agree with the ED on every cost of service adjustment and has asked the ED to furnish additional calculations based on the ALJ's recommendations. However, the ALJ only disagrees with the ED on minor points. Even without recalculations, it is sufficiently clear that the ALJ's recommendation would yield a revenue increase only slightly different from what the ED recommends. Based on that, the ALJ finds that the revenue increase he is recommending would be far less than 51% of what the Applicant sought. For that reason, the ALJ finds that all of the requested rate case expense should be disallowed and no remand is necessary to consider the additional claimed rate case expense.

XII. SUMMARY OF EXPENSES

Because of the complexity of the recalculations needed based on the ALJ's conclusions, the ALJ asks the ED to submit a recalculation and summary of the Utility's expenses and to provide that with the ED's own exceptions. The other parties are invited to respond to the ED's recalculation when they file responses to exceptions.

XIII. OTHER REVENUES

Net income is the total revenues of the utility less all reasonable and necessary expenses as determined by the regulatory authority. [225] All parties recognize that the Applicant's other revenues must be subtracted from its total expenses to determine the Utility's net cost of service.

---

[224] ED Ex. 2 at 22.

[225] Water Code § 13.185(d).

The Utility included $50,350 of other revenue in its rates calculation, thus reducing the amount it would need to recover through rates. That includes test year revenue from late fees, connection and reconnection fees, tap fees, and inspection fees. It proposes no post-test year adjustment.[226] The other parties do not dispute this other revenue amount.

Additionally, as previously discussed, the ALJ recommends deletion of the $145,921 in other revenue that the Applicant included for its revenue from the LCRA pass through surcharge that its customers paid during the test year. That adjustment is necessary, as the ED and the Protestants agree, due to the disallowance of $158,732, which the Applicant included in its cost of service for water purchased from LCRA.

XIV. REVENUE REQUIREMENT SUMMARY

The Applicant originally claimed that its adjusted test year revenue requirement was $498,225, but ultimately revised that downward to $403,236.[227] The ED claims that the Utility's revenue requirement is actually only $179,548[228] and the Protestants claim it is $182,056.[229]

Due to the complexity of the calculations, the ALJ cannot state the precise revenue requirement that would result from his recommendations, but it is relatively close to what the ED and the Protestants propose. The ALJ asks the ED to recalculate the Utility's revenue requirement based on the ALJ's recommendations and to submit the amount with the ED's exceptions.

---

[226] Applicant Ex. 20 at 33.

[227] Applicant Ex. 4 at Spreadsheet tab at 29; Ex. 13 at 29 & Ex. 20 at 13 & 35-36.

[228] ED Ex. 1 at 18 & EP-2.

[229] Tr. 630.

XV. FINANCIAL INTEGRITY

The Applicant correctly notes that Water Code § 13.183(a)(2) requires the Commission to fix a utility's overall revenues at a level that will preserve the financial integrity of the utility. It also notes that the Commission may approve alternative ratemaking methodologies based on factors other than rate of return.[230] Based on those provisions, the Applicant argues that if the Commission adopts the ED's and the Protestants' recommendations, the rates will be insufficient to maintain its financial integrity. The other parties disagree with the Applicant's financial integrity claim.

The ALJ cannot find that the Utility has shown that rates should be set at a higher level to protect its financial integrity.

The Protestants broadly respond that the Applicant is really asking the Commission to bail it out at the expense of the ratepayers. It contends that the Utility has been negligently managed, has misused customer contributions, delivered horrendous services at exorbitant rates, and over-borrowed to improve the ability of its owner, Mr. Hammett, to sell his lots. They claim financial integrity cannot and should not be achieved at all costs. Not all of that has been proven, but the Applicant has the burden of proof not the Protestants.

To preserve its financial integrity, the Utility specifically argues that the Commission must: (1) approve all of the known and measurable changes recommended by Mr. Raushcuber; (2) included an amount to allow it to make its entire loan payment—not just pay interest; and (3) allow its investors to make some profit. The ALJ does not agree.

---

[230] Water Code § 13.183(c).

The Applicant offered a balance sheet purporting to show that as of the end of the test year its total assets of $1,283,218 exceeded its total liabilities of $2,229,917 by $946,699.[231] There is no shareholder equity. However, the evidence does not indicate that shareholder equity has been wiped out due to low rates and high service costs or cash flow problems resulting from necessary construction of facilities not yet in rate base.

The Utility's profit and loss statement purports to show that during the test year the utility spent $310,141 more on service than its income from rates and other sources.[232] Yet having walked through all of its costs of service above, it is clear to the ALJ that the Utility's rates are not and were not during the test year significantly lower than necessary to cover its reasonable costs of service. Moreover, each of the claimed known and measurable changes recommended by Mr. Raushcuber was considered in detail above. To the extent they were shown to be known, measurable and otherwise appropriate, the ALJ recommended their approval. To the extent they were not, the ALJ cannot agree that they should be approved.

As already discussed, the ALJ recommends a rate of return that is equal to the loan interest rate on the assets that the Applicant has shown are used and useful to provide service. He also recommends that a depreciation expense be included in cost of service for those same assets. The New Tank is by far the largest asset expense reasonably in controversy. The ED very generously implicitly included a known and measurable post-test year change to the number of customers to allow some portion of the New Tank to be included as a used and useful asset. The Protestants do not object to that treatment, and the ALJ recommends its approval. That illustrates that the recommended rates have not been cut to the bone so as to gratuitously cause the Utility financial problems. Instead, the rates would be set to allow a return on assets whose use is reasonably foreseeable in the future.

---

[231] Applicant Ex. 16 at Balance Sheet at 1& 2.

[232] Applicant 16 at 1.

The largest liability on the Utility's balance sheet is for the $1,596,816 Frost Bank loan. That loan exceeds the total $1,264,726 value that the Utility claims on its balance sheet for all of its facilities, including some not in service. Yet the Utility borrowed even more money. After the Frost Bank loan, the next largest liabilities are $202,119 owed to Mr. Hammett and $193,132 listed as "Intercompany Payable," which the attached General Ledger reveals is owed to the Land Company.[233] In other words, $395,251 of the Company's claimed $946,699 debt is owed to its affiliates that are the utility's general manager, its managing member, and the president of that managing member. Together they completely control the Utility. There is no evidence to reasonably explain why they authorized so much borrowing in the Utility's name, much less any showing that it was necessary to provide service.

Putting all of the above together shows that the affiliates who control the Utility have:

- acquired in the Utility's name far more assets than necessary to serve the Utility's customers now or in the reasonably foreseeable future;
- borrowed in the Utility's name very large amounts of money that were not necessary to provide service to the Utility's customers;
- borrowed in the Utility's name even more money that far exceeds the value of all of the Utility's assets, including those not currently necessary to provide service;
- borrowed very large amounts of money relative to the Utility's size and stockholder's invested capital; and
- borrowed a very large percentage of the above amounts from themselves.

The ALJ concludes that the Utility's owners have irresponsibly managed the Utility's finances. The ALJ further concludes that Water Code § 13.183(a)(2) does not require the Commission to fix a utility's overall revenues at a level that will preserve the financial integrity of a utility when the utility's owners and managers have irresponsibly managed its finances. The

[233] Applicant Ex. 16 at General Ledger at

ALJ finds that the Utility has failed to show that its rates should be set at a higher level to preserve its financial integrity.

XVI. RATE DESIGN

The Utility has only residential customers with 3/4-inch or smaller meters. There is no evidence that it will have other types of customers in the future. The Utility's monthly rates currently, as originally proposed, and as finally revised during this case are set out below:[234]

	Current	Originally Proposed	Revised
Base rate (½" or ¾" inch meter)	$35.00	$64.00	$61.00
0 to 2000 gal.	$0	$5.00	$5.00
2001 to 10000 gal.	$3.00	$6.00	$6.00
10001 to 20000 gal	$4.00	$7.00	$7.00
20001 gal thereafter	$5.00	$8.00	$8.00

Rates are designed to recover a utility's revenue requirement. Mr. Raushcuber calculated that the revised rate design that he prepared for the Applicant would recover $402,572 per year, which is $664 less than the $403,236 revised revenue requirement that the Applicant claims.[235]

The ED and the Protestants argue that because the Applicant failed to carry its burden of proof concerning revenue requirement, the application should be entirely denied. However, the ED's Mr. Dickey prepared a rate design that would implement the ED's recommended revenue requirement of $179,548.[236] To develop that rate design, Mr. Dickey divided the cost of service items between fixed and variable costs and developed a rate design that would recover the fixed

---

[234] Applicant Ex. 13 at 29, Ex. 4 at Spreadsheet tab at 29 & Ex. 20 at 7 & 36; ED Ex. 2 at 19-20.

[235] Applicant Ex. 13 at 29.

[236] ED Ex. 2 at 22 & BDD-3.

costs through a flat rate per connection and the variable costs through gallonage charges. There is no evidence of disagreement concerning Mr. Dickey's classification of cost of service items as fixed or variable, and the ALJ agrees with Mr. Dickey's classifications. Mr. Dickey's rate design is set out below:

	Mr. Dickey's Rate Design
Base rate (½" or ¾" inch meter)	$38.73
0 to 2000 gal.	$0
2001 to 10000 gal.	$3.00
10001 to 20000 gal	$4.00
20001 gal thereafter	$5.00

The ALJ does not agree with the every recommendation of the ED, but the ALJ's conclusions are sufficiently close to the ED's that it would appear that a recalculation would lead to a slight increase in the Utility's current base rates. The ALJ sees no reason to entirely deny the application if the Applicant has shown that at least a small increase is in order.

The ALJ adopts Mr. Dickey's classification of cost of service items and rate design methodology. He asks the ED to recalculate a rate design that would recover the revenue requirement that would result from the ALJ's conclusions in this PFD and to provide those with the ED's exceptions. If the recalculation of rate design indicates a slight increase, than the ALJ would recommend that the Commission adopt that increase and otherwise deny the Utility's application.

XVII. TRANSCRIPTION COSTS

Because the hearing was scheduled for more than one day, the ALJ ordered the Applicant to arrange for and pay a court reporter to record and transcribe the hearing on the merits and to deliver the original transcript to the ALJs and two copies to the TCEQ's Chief. He also indicated

that when the Commission made a final decision in this case, the costs of the recording and transcription would be allocated among the parties in accordance with 30 TAC § 80.23.

The Applicant argues that the cost of the transcript should be included as a rate case expense. Alternatively, it contends that each party should be assessed the cost for its own copy of the transcript and the remaining costs should be allocated, apparently equally, among AGX, Ms. Hawken, and the Applicant. The Protestants argue that the Applicant should bear the entire cost of transcript.

The ALJ agrees with the Applicant that the Protestants should bear the cost of the copy of the transcript, if any, that they ordered for their own use. But he agrees with the Protestants that the Commission should assess the entire remaining transcript costs against the Applicant.

The Commission's rules provide that the Commission will not assess transcript costs against the ED or the OPIC and that it will consider the following relevant factors in allocating reporting and transcription costs among the other parties:

- the party who requested the transcript;
- the financial ability of the party to pay the costs;
- the extent to which the party participated in the hearing;
- the relative benefits to the various parties of having a transcript;
- the budgetary constraints of a state or federal administrative agency participating in the proceeding;
- in rate proceedings, the extent to which the expense of the rate proceeding is included in the utility's allowable expenses; and
- any other factor which is relevant to a just and reasonable assessment of costs.

Because the ALJ ordered the transcript, no party requested it, though they may have ordered copies for their own use. The Applicant and the Protestants fully participated and benefited from the transcript, as evidenced by their post-hearing briefs.

There is no evidence concerning the Protestants' ability to pay for a transcript, although the Applicant infers that AGX and Ms. Hawken can pay because they hired a lawyer to represent them in this case. Though the Applicant claims that its finances are endangered, the Applicant apparently paid for the court reporter as ordered and the transcript was delivered. The ALJ concludes that the Applicant can pay for the cost of the transcript.

Because the evidence does not show that an increase of at least 51% of the revenue that the Applicant applied for is warranted, the Utility is not entitled to recover its rate case expenses from customers.[237] For that same reason, the ALJ concludes that it would be more just for the Applicant to be assessed the entire cost of the transcript.

XVIII. REFUNDS

Unless otherwise agreed to by the parties to the rate proceeding, the utility shall refund or credit against future bills all sums collected during the pendency of the rate proceeding in excess of the rate finally ordered plus interest as determined by the regulatory authority.[238] The ALJ recommends that the Commission order the Applicant to refund to its customers all sums collected in excess of the rates finally set in this case plus interest.

There is no specific evidence or argument concerning either the appropriate rate of interest or the term over which the refunds should occur. The ALJ asks to parties to address these points in their exceptions.

---

[237] 30 TAC § 291.28 (7) and (8).

[238] Water Code § 13.187(i).

XIX. SUMMARY

The ALJ recommends that the Commission adopt the attached proposed order with revisions that the ALJ will submit following receipt of the ED's recalculations based on the ALJ's recommendation.

SIGNED July 1, 2010.

WILLIAM G. NEWCHURCH
ADMINISTRATIVE LAW JUDGE
STATE OFFICE OF ADMINISTRATIVE HEARINGS

TEXAS COMMISSION ON ENVIRONMENTAL QUALITY

AN ORDER
GRANTING IN PART AND DENYING IN PART THE APPLICATION OF DEER CREEK RANCH WATER CO., LLC TO INCREASE ITS WATER RATES UNDER CERTIFICATE OF CONVENIENCE AND NECESSITY NO. 11241 IN TRAVIS AND HAYS COUNTY, TEXAS
SOAH DOCKET NO. 582-09-5328
TCEQ DOCKET NO. 2009-0929-UCR

On _____, the Texas Commission on Environmental Quality (TCEQ or Commission) considered the application of Deer Creek Ranch Water Co., LLC to increase its water rates under Certificate of Convenience and Necessity No. 11241 in Travis and Hays Counties, Texas. A Proposal for Decision (PFD) was presented by William G. Newchurch, an Administrative Law Judge (ALJ) with the State Office of Administrative Hearings (SOAH), who conducted a contested case hearing concerning the application on March 22 and 23, 2010, in Austin, Texas.

After considering the ALJ's PFD, the Commission adopts the following Findings of Fact and Conclusions of Law:

I. FINDINGS OF FACT

Introduction

1. Deer Creek Ranch Water Co., LLC (Applicant or Utility) has applied to increase its rates for the water service it provides under its Certificate of Convenience and Necessity (CCN) No. 11241 in Travis and Hays County, Texas.

2. The following are the parties in this case:

PARTY	REPRESENTATIVE
Applicant	Randall B. Wilburn
Executive Director (ED)	Brian D. MacLeod
Office of Public Interest Counsel (OPIC)	James B. Murphy
AGX, Inc.	David M. Gottfried
Anne Hawken	David M. Gottfried
Jennifer Jones	self
Cristina Chavez	self
Royce H. Henderson	self
Chris Elder	self
Jonathan McCabe	self
Bradley and Stephanie Weaver	selves

3. Except as otherwise noted, AGX, Inc.; Anne Hawken; Jennifer Jones; Cristina Chavez; Royce H. Henderson; Chris Elder; Jonathan McCabe; and Bradley and Stephanie Weaver are referred to collectively as Protestants.

4. The following are the key events in this case:

DATE	EVENT
February 27, 2009	Application filed.
February 28, 2009	Notice of rate increase mailed to customers.
May 1, 2009	Effective date of rate increase.
July 31, 2009	Notice of preliminary hearing mailed to customers.
August 13, 2009	Preliminary hearing.
September 4, 2009	Discovery Began.
September 11, 2009	Parties identified applicable statutory and regulatory law.
October 2, 2009	Deadline to serve written discovery requests.
November 6, 2009	Applicant to prefile its direct case in writing, including all testimony and exhibits.
November 20, 2009	Parties other than Applicant and ED to prefile their direct cases in writing, including all testimony and exhibits.
December 23, 2009	ED files his direct case in writing, including all testimony and exhibits.
January 8, 2010	Deadline to take depositions.
January 22, 2010	Deadline to file objections to and motions to strike any prefiled evidence.
January 29, 2010	Deadline to file responses to objections and motions to strike prefiled evidence.

February 5, 2010	Mediated settlement conference. Agreement was not reached during the mediation.
February 12, 2010	Prehearing conference to set times and orders of witnesses and rule on pending objections and motions.
March 22, 2010	Hearing on the merits (HOM) of case began.
March 23, 2010	End of HOM.
April 6, 2010	Transcript delivered.
April 27, 2010	Deadline to file written closing arguments.
May 4, 2010	Deadline to file replies to closing arguments.
July 5, 2010	PFD due date.

Affiliates

5. Deer Creek Ranch, Inc. (Land Company) is the managing member of the Utility.

6. Sam Hammett is the General Manager of the Utility. He also is president of and owns shares in the Land Company.

7. As defined by TEX. WATER CODE ANN. (Water Code) § 13.002(2), the Land Company and Sam Hammett are affiliates of the Utility.

Overview of Revenue Requirement Dispute

8. The Applicant originally claimed that its adjusted test year revenue requirement was $498,225, but ultimately revised that downward to $403,236.

9. As set out below, the Utility's just and reasonable revenue requirement is $_____.

Operational Expenses
Post-Test Year Inflation Adjustments

10. The test year for this case is July 1, 2007, through June 30, 2008.

11. The Utility proposed a post-test year inflation adjustment of 10% for many expense items.

12. In computing a utility's allowable expenses, only the utility's historical test year expenses as adjusted for known and measurable changes may be considered. 30 TEX. ADMIN. CODE (TAC) §291.31(a) and (b).

13. "Test year" means the most recent 12-month period for which representative operating data for a retail public utility are available. Water Code § 13.002(22).

14. There is not sufficient evidence to show that the Applicant's proposed 10% adjustments for inflation are based on known and measurable changes.

15. All of the Applicant's proposed 10% inflation adjustments should be disallowed.

Salaries and Wages

16. The Applicant seeks $51,600 for salaries and wages.

17. The salary and wages amount should be reduced to $12,915.

18. The Applicant contends that it paid $49,200 for salaries during the test year: $24,600 to Chris Aaron, who is the Applicant's full time licensed water operator, and $24,600 to Sam Hammett, the Chief Operations Officer.

19. The Utility also included a 5% post-test year adjustment to give each employee a merit and cost of living increase.

20. The Utility pays an independent contractor—Professional General Management Services, Inc. (PGMS)—for water operations, office administration, customer service, preparation of annual reports, *etc.*

21. During the test year, the Applicant paid PGMS $57,489.93 for those services, which it included as a contract labor expense.

22. During the first half of 2007, the Land Company had a tax ID number, but the Utility did not. Since the second half of 2007, the Utility has had its own tax ID number.

23. In the first half of 2007, salary amounts for Mr. Hammett and Mr. Aaron were reported under the Land Company's tax ID number.

24. W2s for 2007 show that Chris Aaron and Sam Hammett were together paid only $24,600.

25. Mr. Aaron had his own company, Aaron Maintenance, for which he worked ten hours a week during the test year.

26. The evidence is insufficient to show that Mr. Aaron worked full time for the Utility during the test year. One-half of the test year salary claimed for Chris Aaron, $12,300, should be disallowed.

27. The 5% post-test year adjustment for a merit raise for Mr. Aaron is known and measurable and should be allowed.

28. Mr. Hammett lives in Mississippi.

29. The evidence is insufficient to show that the salary paid to Mr. Hammett was an appropriate affiliate transaction.

30. The $24,600 claimed for Mr. Hammett's salary should be entirely disallowed.

Contract Labor

31. The Applicant seeks $75,766 for contract labor. Of that amount, $13,000 should be disallowed, and the remainder should be allowed as reasonable and necessary.

32. Of that contract labor amount, $14,430 should be disallowed, and the remainder should be allowed as reasonable and necessary expenses of providing service.

33. The evidence is insufficient to show that $2,000 paid to Aaron's Maintenance was a necessary and reasonable expense to provide water service, and it should be disallowed.

34. Jeanne Cutrer works for Cutrer Administration at the Utility's office and handles customer phone calls and billing for the Utility, but PGMS also handles those tasks.

35. The Utility's phone number and address don't appear on customer's bills. Instead, the phone number and address on the bills belong to PGMS.

36. The evidence is insufficient to show that it was necessary and reasonable to provide water service for the Utility, which had only 367 customers at the end of the test year, to have paid both PGMS and Cutrer Administration for similar and overlapping contract services.

37. The $11,000 paid to Cutrer Administration should be disallowed.

38. Tank cleaning is not required every year.

39. A $2,876 expense that the Utility paid for tank cleaning should be allowed as a reasonable and necessary annual expense.

Water Purchased From LCRA

40. The Utility claims $158,732 should be included in its cost of service for water purchased from the Lower Colorado River Authority (LCRA). This entire amount should be disallowed.

41. During the test year, the Utility spent $98,206.40 to purchase water from LCRA. All of that purchase was for water consumed from February 2008 through June 2008.

42. The $158,732 sought by the Utility is based on post-test year adjustments projecting that water consumption from February 2008 through June 2008 would continue for a full year and that water costs would increase by 10% due to inflation.

43. The evidence is insufficient to show that these post-test year adjustments are based on known and measurable changes.

44. Pursuant to a settlement agreement in a prior case in February 2005, the Utility's customers are already paying a pass through charge for water the Utility purchases from LCRA.

45. There is no reason to include a component in cost of service and higher base rates based on estimated costs of purchasing LCRA water when the Applicant is already authorized to directly pass through and recover the exact costs and can seek to amend the surcharge calculation method if it is deficient.

Water Testing / Chemicals

46. The Applicant seeks $5,131 for water testing and chemicals. This was a necessary and reasonable expense of providing water service.

Utilities (Electrical)

47. The Applicant claims an expense of $8,693 for electric utility service. This was a necessary and reasonable expense to provide water service.

Repair and Maintenance

48. The Applicant seeks to include $4,519 for repair and maintenance.

49. Of that claimed repair and maintenance expense, $411 should be disallowed, and the remainder should be allowed.

50. During the test year, the Applicant incurred $4,108 in repair and maintenance expenses, and the claimed amount includes a 10% post-test year inflation adjustment of $411.

51. The evidence is insufficient to show that the inflation adjustment is based on a known and measurable change.

Materials and Supplies

52. The Utility seeks $13,147 for materials and supplies. This was a necessary and reasonable expense to provide water service.

Office Expense

53. The Applicant claims $4,066 for office expenses. This entire amount should be disallowed.

54. The expense is for office space in a building owned by Ward Energy.

55. Space for both the Utility and the Land Company are included in the same lease, though each has a physically distinct office. The square footage is nearly the same: 175 square feet for the Land Company and 170 square feet for the Utility. The Applicant split the lease expense equally between the Land Company and the Utility.

56. The Utility also owns a service building where the office could be moved, and the office expense could be eliminated.

57. PGMS, which already provides many contract management services for the Utility, could run the entire operation, which would mean no office space was needed.

58. Utility office space is not needed for Jeanne Cutrer of Cutrer Administration, since its services unreasonably duplicate PGMS's.

59. Utility office space is not needed for Sam Hammett, since he lives in Mississippi. Additionally, the evidence is insufficient to show that he works for the Utility halftime and his salary is an appropriate affiliate expense.

60. The evidence is insufficient to show that the expense of the office space was reasonable and necessary to provide service.

Auto Expense

61. The Utility claims an auto expense of $2,830. That is approximately 50% of the cost of a mortgage loan paid for a Ford F150 truck.

62. The truck is used by two affiliates of the Utility: the Land Company and Mr. Hammett.

63. It is reasonable to allocate 50% of the expense of the truck to the Utility.

64. The truck was purchased in 2006 and has a service life of 20 years.

65. After subtracting accumulated depreciation, the truck has a remaining net value of $15,078.

66. The claimed $2,830 expense for the truck should be disallowed, and the truck's $15,078 remaining net value should be added to invested capital, with a service life of 20 years. That will yield a return on that value plus annual depreciation of $850.

Auto Expense Gasoline

67. The Applicant seeks $1,525 in auto gasoline expenses for the Ford F150 truck.

68. To account for its use by the affiliates, the Utility claims 50% of the actual test year gasoline expense for the F150 truck.

69. The Applicant increased that test year gasoline cost by 10% to account for estimated post-test year inflation.

70. The evidence does not show that the inflation adjustment is based on known and measurable changes.

71. The inflation adjustment should be disallowed.

72. The reasonable and necessary cost of gasoline to provide water service is $1,386.

Telephone Expense

73. The Utility claims a telephone expense of $3,861, which includes the cost of Chris Aaron's cell phone, an office phone, and internet and long distance services. No inflation adjustment was included.

74. The $3,861 was a necessary and reasonable expense to provide water service.

Printing Expense

75. The Utility claims a $352 printing expense, which includes the test year amount of $320 and a 10%, $30 inflation adjustment.

76. The evidence does not show that the inflation adjustment was based on a known and measurable change in costs.

77. The $30 inflation adjustment should be disallowed.

Equipment Rental Expense

78. The Applicant seeks to include $5,083 for equipment rented during the test year to repair and maintain its water system. It proposes no inflation adjustment to this expense.

79. The evidence is insufficient to show that the Utility spent $5,082.68 for equipment rental and that it was reasonably needed to provide water service.

80. The entire $5,083 claimed by the Applicant for equipment rental should be disallowed.

Insurance Expense

81. The Applicant claims an insurance expense of $14,559 for health insurance for the Utility's employees and for general and facility damage insurance. That includes an upward of 10% to account for anticipated post-test year inflation.

82. Of the claimed amount, $7,751 should be allowed as a reasonable and necessary expense and the remainder should be disallowed.

83. The general and facilities damages insurance, which totals $2,266.06 paid to Galloway Insurance, was a necessary and reasonable cost of providing water service.

84. The evidence does not show that the inflation adjustment of $1,324 is based on a known and measurable post-test year change.

85. The Utility paid $3,417 during the test year to Union Insurance for vehicle insurance for the F150 truck previously discussed.

86. Fifty percent of the auto insurance expense, or $1,709, should be disallowed due to the use of the truck by the Utility's affiliates that was not necessary or reasonable to provide water service.

87. The claimed test year expense for health insurance is $7,552.55.

88. The health insurance policy covers Susan and Sam Hammett and Chris Aaron.

89. There is no evidence that Susan Hammett is an employee of the Utility.

90. The evidence is insufficient to show that Mr. Aaron worked full time for the Utility during the test year.

91. The evidence is insufficient to show that Mr. Hammett worked full time for the Utility during the test year.

92. Based on the above, it would be reasonable to disallow 50% of the claimed health insurance expense, or $3,776.

Postage Expense

93. The Applicant seeks to include $423 in its cost of service for postage expense. This includes the $385 that it actually spent during the test year and a 10% inflation adjustment.

94. The evidence is insufficient to show that the inflation adjustment is a known and measurable post-test year change; hence, it should be disallowed.

95. Expenses for postage totaling $385 are reasonable and necessary.

Payroll Tax Expense

96. The Applicant seeks to include $4,030 in its cost of service for its payroll taxes. This includes a claimed actual test year expense of approximately $3,840 and an adjustment to account for post-test year salary inflation that it anticipates.

97. The payroll tax amount should be 7.65% of the salary amount.

98. As discussed above, the necessary and reasonable adjusted salary amount is $12,915.

99. Based on the above, the Utility's necessary and reasonable payroll tax expense to provide service is $988.

Property and Other Taxes

100. The Utility claims $7,110 for property taxes. That includes claimed test year taxes of $6,470 and a 10% inflation adjustment of $640.

101. The evidence is insufficient to show that the inflation adjustment is a known and measurable change. It should be disallowed.

102. The evidence is insufficient to show that the Utility's test year property taxes were $6,470.

103. The Utility's necessary and reasonable test year property tax expense to provide water service was $6,152, which should be allowed.

Miscellaneous Expense

104. During the test year, the Utility had minor miscellaneous expenses of $683 for supplies, TCEQ inspections, and solid waste disposal that were necessary and reasonable to provide water service.

Loans

105. The Applicant originally sought to include $13,932 in cost of service for interest payments to Wells Fargo Bank and interest and principle payments to Mr. Hammett for loans allegedly borrowed to pay for operation and maintenance expenses.

106. The Utility also originally included $95,809 for interest payments on funds allegedly borrowed from Frost Bank for capital projects.

107. The Utility has withdrawn both of the above requests and neither the $13,932 nor the $95,809 should be included in its costs of service.

Professional Fees

108. The Applicant seeks $13,380 in cost of service for professional fees that it incurred during the test year. That includes $2,560 for accounting fees and $9,330 for routine legal fees. It also includes $1,520 for five years to recover $7,588 spent on legal fees related to the Applicant last rate case, which was settled.

109. The accounting work was performed during the test year, July 1, 2007, through June 30, 2008, but concerned a tax return for a prior tax year.

110. Prior to the second half of 2007, the Utility did not have its own tax ID number and used the tax ID number for the Land Company because they were treated as one entity for tax purposes.

111. Based on the above, the tax work performed for a year before the test year must have been for the Land Company and the Utility as a combined entity, not just for the Utility.

112. Fifty percent, or $1,280, of the accounting fees should be disallowed because the accounting work was performed for both the Utility and the Land Company. The remaining $1,280 should be allowed as a necessary and reasonable expense.

113. Of the routine legal fees, $6,612 was for non-recurring work related to a transmission line improvement, which should be removed from cost of service and recovered through an amortization charge of $1,322 per year for five years. The remaining $2,718 in routine legal expenses should be allowed as a reasonable and necessary expense.

114. Rate case expenses for a prior case for which the Commission approved a settlement should not be recoverable in a subsequent rate case unless the settlement specifically provided for that possible recovery.

115. The $1,520 for five years that the Utility seeks to include for legal expenses for a prior rate case should be disallowed.

Lease for the Pre-1985 Assets

116. On March 1, 2005, the Utility and its affiliated Land Company entered into a surface and facilities lease agreement (Lease). It gave the Utility the right to use certain assets that were constructed prior to July 1985 (Pre-1985 Assets).

117. The Utility originally claimed that the Pre-1985 Assets should be included in its rate base, but it has withdrawn that request.

118. The rent stated in the Lease was $1,125 per month for the first year, and the Lease included a rent adjustment clause for subsequent years.

119. The Applicant seeks to include an annual amount of $13,500 in cost of service for the Lease.

120. The entire $13,500 should be disallowed.

121. At one time, the Land Company held the CCN that the Utility now holds, used the Pre-1985 Assets to provide water service then, and still owns those assets.

122. On October 4, 1985, the Land Company still held the CCN and filed a rate change application with the Commission's predecessor agency, hereafter also referred to as "the Commission."

123. On April 15, 1986, the Commission issued an order approving that application in part and denying it in part.

124. In that 1986 order, the Commission found the original costs of certain assets, including the Pre-1985 Assets, which are set out below:

Asset	Original Costs 1986 Order
Well	$16,523.58
100000-gallon storage tank	$35,000
Distribution system	$120,170
Office furniture and equipment	$253
TOTAL	**$171,946.58**

125. In the 1986 Order, the Commission also found that:

a) Only 50% of the distribution system, or $60,085, was used and useful;

b) $3,000 of the 100,000-gallon tank's cost was unreasonable;

c) Customers had contributed $105,560, which had to be deducted from rate base; and

d) $7,988 in deprecation had accumulated.

126. After make those deductions, the Commission found in the 1986 Order that the Land Company only had $18,882 in net plant that was used and useful to provide service. The Commission also found that the depreciation expense was $3,092 per year.

127. On July 15, 2005, the Commission approved the transfer of the CCN from the Land Company to the Utility (CCN Transfer Order).

128. The CCN Transfer Order did not generally authorize the Utility to lease facilities and lines from the Land Company and did not approve the specific March 1, 2005, Lease.

129. The CCN Transfer Order stated, ". . . Certificate of Convenience and Necessity No. 11241 [was] transferred in accordance with the terms and conditions set forth in the certificate." The certificate stated, "[The Land Company's] facilities and lines were transferred to [the Utility] (CCN No. 11241) in Hays and Travis Counties."

130. The Pre-1985 Assets that were found used and useful in Commission's 1986 Order would have been fully depreciated and had no remaining net value if they had been transferred to the Utility as directed in the CCN Transfer Order.

131. Circumstances have changed since the 1986 Order was issued, and the entire distribution system is now used and useful. Thus, the other 50% of the distribution system assets, with an original cost of $60,085, is now used and useful.

132. Additionally, the following Pre-1985 Assets are also used and useful now: electric and control facilities with a projected original cost of $2,000 and a hydropneumatic tank with a projected original cost of $12,600.

133. Those additional Pre-1985 Assets, worth $72,685, have accumulated depreciation since they were put into use.

134. The annual payment of $13,500 to lease the Pre-1985 Assets gave the Utility's affiliated Land Company more than an 18.57% annual return on those assets with an original cost of $72,685. Once depreciation was subtracted from the original costs of those assets, the return would be even higher.

135. The evidence is insufficient to show that the Lease is an appropriate affiliate transaction.

Working Cash Allowance

136. The Utility should be allowed a working cash allowance equal to one-eighth of its total annual operations and maintenance expense excluding amounts charged to operations and maintenance expense for materials, supplies, and prepayments (operations and maintenance expense does not include depreciation, other taxes, or federal income taxes). 30 TEX. ADMIN. CODE (TAC) § 291.31(c)(2)(B)(iii).

137. The Utility reasonable and necessary working cash allowance is $_____.

Return on Investment

138. The Applicant seeks a total return on investment of $111,910.

Invested Capital
Assets Owned by Others Not Included

139. The Applicant claims that it is entitled to earn a return on $2.71 million in assets that Mr. Hammett personally owns (Hammett Assets) and has pledged as collateral for a $1.6 million loan to the Utility from Frost Bank to the Applicant.

140. These include two of Mr. Hammett's brokerage accounts with Frost Brokerage Services, his shares in the Land Company, and certain real estate lots at the Land Company's development.

141. All of the Hammett Assets should be removed from the Utility's rate base because they are not the Utility's assets.

Assets Owned by the Utility

142. The Applicant claims that it has used and useful capital assets that were constructed after June 2000 with an original cost of $1,325,069.

143. As set out below, the original cost of the Utility's in-plant assets that are used and useful to provide service is $1,043,135. After deducting accumulated depreciation, the net plant is $1,038,240.

New Ground-Storage Water Tank

144. The Utility has a new 109,500-gallon, ground-storage water tank (New Tank).

145. Eighty-eight percent of the New Tank is not reasonably useful to provide service.

146. Eighty-eight percent of the New Tank's original cost, or $78,945.78, should be disallowed, and the remainder should be allowed.

147. In addition to the New Tank, the Utility still uses a 100,000-gallon ground storage tank that was built before July 1985 (Old Tank). The Old Tank is one of the Pre-1985 Assets that is owned by the Land Company and Leased by the Utility.

148. Under 30 TAC § 290.45(b)(2)(E), a utility must have a storage capacity of 200 gallons per connection.

149. The Utility had 367 connections at the end of the test year.

150. The Old Tank's 100,000-gallon volume provides significantly more than the 73,400 gallons of storage necessary to achieve the required 200 gallons per connection.

151. Two areas that the Utility may serve in the future have 131 and 67 lots.

152. To serve its 565 current and possible future connections would eventually require 113,000 gallons of ground storage capacity, which are 13,000 more than the Old Tank provides.

153. The difference between the 367 end of test year customers and 565 customers is a very large 54% post-test year increase.

154. The 200 gallons per connection storage requirement is only a minimum. 30 TAC § 290.45(a)(1).

155. Greater capacity may be required if a normal operating pressure of 35 psi, or 20 psi during unusual conditions, cannot be maintained. 30 TAC § 290.45(a)(2).

156. Alternative capacity requirements, in lieu of the required minimums, may be allowed upon a detailed showing that is approved by the ED. 30 TAC § 290.45(g).

157. There is no evidence to show that more than the minimum storage capacity is necessary to maintain a pressure of 35 psi, or 20 psi in unusual conditions.

158. There is no evidence to show that more that the required minimum storage capacity has been approved by the ED or that the Utility has even applied for such approval.

159. Only 13,000 gallons, or 12%, of the New Tank's capacity is used and useful to provide storage.

160. The LCRA contract requires a physical separation (air gap) between LCRA's wholesale water supply and the Applicant's retail water supply.

161. An air gap prevents backflow of water to the LCRA.

162. There is no air gap at the site of the Old Tank.

163. The New Tank provides the air gap. Water from LCRA is piped to the top of the tank and allowed to fall to the bottom, so the empty upper portion of the tank space is the physical separation between the LRCA inflow and the Utility's water at the bottom of the tank.

164. The Old and New Tanks are approximately one mile apart.

165. The air gap could not be placed near the Old Tank because the Utility's internal plumbing would have to be used to pump water there, thus the Utility's system would not be physically separated from LCRA's.

166. A 50,000-gallon tank could have been used to supply the air gap.

167. The evidence is insufficient to show that the full $89,711.11 expense of the New Tank was reasonable to provide an air gap.

Plugging of South and North Wells

168. The Utility seeks to include in its rate base $1,794.33 that it spent to plug its South well and $2,116.83 that it spent to plug its North well.

169. The plugging expenses for the North and South wells were incurred on June 29 and 30, 2005, which were before the test year.

170. The wells had already been fully depreciated; hence, they are no longer used and useful to provide service.

171. A plugged well can no longer be used for a backup water supply.

172. The costs of plugging the wells were neither capital investments with ongoing useful lives that are used and useful to provide service nor test year operational expenses.

173. The expenses of plugging the North and South wells should be entirely disallowed.

Well Pumps

174. In its requested rate base, the Utility included $4,282.41 for a well pump put in service on June 9, 2000, and $12,208.34 for a well pump put in service on August 18, 2003.

175. The evidence does not show that these well pumps are used and useful to provide water service.

176. These costs of the well pumps should be disallowed.

Fire Hydrants

177. In its requested rate based, the Utility included $23,800 that was paid to install seven fire hydrants.

178. Fire protection is not retail water service.

179. The cost of the fire hydrants should be disallowed.

Truck

180. As discussed above in this Order, no portion of the cost of the 2006 F150 truck should be allowed as an operating expense.

181. The $15,078 remaining net value of the 2006 F150 truck should be included in invested capital, with a service life of 20 years and annual depreciation expense of $850.

Invested Capital Reduction Due To Customer Contribution

182. As of April 30, 2009, the Utility's customers had paid $167,781 under a surcharge adopted in settlement of a rate case in 2005.

183. The Commission approved a settlement agreement in that case, which authorized the Utility to collect a surcharge of $12.00 per month per customer for five years to collect sufficient revenue to pay for improvements to the water system.

184. The Utility's invested capital should be reduced by the entire $167,781 that the customers have paid in accordance with the surcharge provided for in the settlement of the rate case in 2005.

Return on Investment

185. The Utility claims that the reasonable rate of return on its invested capital is 12.5%.

186. The reasonable rate of return on the Utility's invested capital is 6.0%.

Cost of Equity

187. The Commission has adopted a rate of return worksheet and included that in its rate change application instructions. Starting with the most current average return on Baa

rated public utility bonds as a base, the worksheet provides for upward adjustments of up to 8.0% for certain systems.

188. The rate of return worksheet is consistent with and applies rate of return principles set out in the Water Code and the current rules. Water Code § 13.184 and 30 TAC § 291.31(c)(1).

189. The rate of return worksheet ensures access to credit by starting with the current rate of return on publicly traded bonds, which reflect debt with a zero risk of return.

190. The rate of return worksheet ensures access to equity markets by allowing for upward adjustments to reflect systems with higher risks to capital, including systems with small numbers of customers, low growth, unstable populations, and aging facilities.

191. Upward adjustments are also allowed when the Utility's management conserves water resources and provides high quality of service and good management.

192. The Commission has approved a 12% rate of return for some utilities in the past, but not higher.

193. The average rate of return on Baa public utility bonds for the last 12 months, according to Moody's, was 7.45%.

194. Given the current 7.45% Baa bond rate and the possibility of upward adjustments totaling 8.0%, the calculation methodology set out in the worksheet allows for the possibility of a 15.45% rate of return.

195. The rate of return worksheet is reasonably consistent with the Commission's historical practice and potentially more generous to a utility.

196. No upward adjustments to the Utility's rate of return are warranted under the Commission's rate of return worksheet.

197. The evidence is insufficient to show that a rate of return on equity higher than 7.45% would be necessary and reasonable.

198. Using the rate of return worksheet method of calculation, the Utility's reasonable return on equity would be 7.45%.

Cost of Debt

199. At the end of the test year, the Utility owed Frost Bank $1,596,816 for loans with an annual interest rate of 6.0%.

200. The Utility also had an auto loan of $18,860 at 7.49% interest. That should be reduced by $9,430, to reflect the allocation of 50% of the auto debt to the Utility and 50% to the non-utility.

Using a Weighted Cost of Capital Is Not Reasonable In This Case

201. The net value of the Utility's used and useful assets is $1,038,240; however, its total debt is $1,606,246.

202. The Utility has negative equity; it owes $568,006 more than the net value of its used and useful invested capital.

203. When a utility has negative equity, all of its invested capital has been financed with debt.

204. When a utility has outstanding debt and positive equity, using a weighted cost of capital properly prevents the utility receiving a greater than reasonable rate of return on its invested capital.

205. Using a weighted cost of capital approach for a utility with negative equity would not be reasonable because it would result in a return that was lower than the cost of the debt that the utility used to acquire its used and useful invested capital.

206. Because the Utility has borrowed at 6.0% interest more than the net value of its currently used and useful invest capital, the Utility's reasonable rate of return on its invested capital is 6.0%.

207. Because the net value of the Utility's used and useful assets is $1,038,240 and its reasonable rate of return in 6.0%, the Utility's reasonable and necessary return on investment is $62,294.

Annual Depreciation

208. Based on the above Findings of Fact, the Utility's reasonable and necessary annual depreciation expense is $30,004.

Other Expenses
Federal Income Taxes

209. The Applicant has requested that $9,519 be included in the cost of service for the payment of federal income taxes. This amount should be disallowed.

210. The annual interest that the Utility owed on its debt during the test year exceeded the reasonable return on its invested capital that was used and useful to provide service.

211. The Utility will have negative income and owe no federal income tax.

212. The Utility's reasonable expense for federal income tax is zero.

Rate Case Expense

213. The Applicant contends that its expenses for this rate case as of the time it filed its application totaled $27,230. This amount should be disallowed.

214. The Utility also claims that it had approximately another $100,000 in rate case expenses, but there is no evidence in the record to support that claim.

215. The Utility applied to increase its revenue by $104,000 per year.

216. The Utility's just and reasonable rates would generate $_____ of revenue per year which is $_____ more than the $_____ that its current rates would generate.

217. The evidence does not show that the increase in revenue generated by the Utility's just and reasonable rates would be at least 51% of the increase in revenue that would have been generated by the Utility's proposed rates.

Cost of Service

218. Based on the above, the Utility's necessary and reasonable cost of service is $_____.

Other Revenues

219. The Utility's other revenues must be subtracted from its total expenses to determine the Utility's net cost of service.

220. The Utility properly included $50,350 of other revenue in its rate calculation, thus reducing the amount it would need to recover through rates.

221. Additionally, the Utility included $145,921 in other revenue to account for its revenue from the LCRA pass-through surcharge that its customers paid during the test year. This amount should be deleted from other revenue due to the disallowance of $158,732 that the Applicant included in its cost of service for water purchased from LCRA.

Financial Integrity

222. To preserve its financial integrity, the Applicant claims that the Commission must: (1) approve all of the known and measurable changes it claims, (2) include an amount to allow it to make its entire loan payment—not just pay interest, and (3) allow its investors to make some profit.

223. The evidence is insufficient to show that the Utility's rates should be set at higher levels than they otherwise would be in order to protect the Utility's financial integrity.

224. To the extent that the Utility's claimed post-test year changes have not been shown known, measurable, and otherwise appropriate, they should not be approved.

225. The Utility has negative equity.

226. The evidence is insufficient to show that the Utility's shareholder equity has been wiped out due to low rates and high service costs or cash flow problems resulting from necessary construction of facilities not yet in rate base.

227. The evidence is insufficient to show that the Utility's current rates are significantly lower than necessary to cover its reasonable costs of service.

228. The largest liability on the Utility's balance sheet is for a $1,596,816 loan from Frost Bank. That loan exceeds the total $1,264,726 value that the Utility claims on its balance sheet for all of its facilities.

229. After the Frost Bank loan, the next largest liabilities are $202,119 owed to Mr. Hammett and $193,132 owed to the Land Company, both of which are affiliates of the Utility.

230. Together Mr. Hammett and the Land Company completely control the Utility.

231. The evidence is insufficient to show why the affiliates authorized so much borrowing in the Utility's name, much less to show that it was necessary to provide service.

232. The affiliates who control the Utility have:

a) acquired in the Utility's name far more assets than necessary to serve the Utility's customers now or in the reasonably foreseeable future;

b) borrowed in the Utility's name very large amounts of money that were not necessary to provide service to the Utility's customers;

c) borrowed in the Utility's name more money that exceeds the value of all of its assets, including those not currently necessary to provide service;

d) borrowed very large amounts of money relative to the Utility's size and stockholder's invested capital; and

e) borrowed a very large percentage of the above amounts from themselves.

233. The Utility's owners and managers have irresponsibly managed the Utility's finances.

Rate Design

234. The Utility has only residential customers with 3/4-inch or smaller meters. There is no evidence that it will have other types of customers in the future.

235. The Utility's monthly rates currently, as originally proposed, and as it finally revised them during this case are set out below:

Monthly Rates	Current	Originally Proposed	Revised
Base rate (½" or ¾" inch meter)	$35.00	$64.00	$61.00
0 to 2000 gal.	$0	$5.00	$5.00
2001 to 10000 gal.	$3.00	$6.00	$6.00
10001 to 20000 gal	$4.00	$7.00	$7.00
20001 gal thereafter	$5.00	$8.00	$8.00

Transcription Costs

236. Because the hearing was scheduled for more than one day, the ALJ ordered the Applicant to arrange for and pay a court reporter to record and transcribe the hearing on the merits and to deliver the original transcript to the ALJ and two copies to the TCEQ's Chief.

237. The Applicant paid for the court reporter as ordered and the transcript was delivered. Thus, the Applicant can pay for the cost of the transcript.

238. Because the ALJ ordered the transcript, no party requested it, though a party may have ordered one or more copies for its own use.

239. The Applicant and the Protestants fully participated and benefited from the transcript, as evidenced by their post-hearing briefs.

240. Because the evidence does not show that an increase of at least 51% of the revenue that the Applicant applied for is warranted, it would be more just for the Applicant to be assessed the entire cost of the transcript, except for the cost of copies that the Protestants ordered, if any, for their own use.

II. CONCLUSIONS OF LAW

1. Applicant is a public utility as defined in Water Code § 13.002(23).

2. The Commission has jurisdiction to consider an application for a rate increase filed by a public utility, pursuant to Water Code § 13.181.

3. The ALJ conducted a contested case hearing and issued a proposal for decision on the Applicant's proposed water rate changes under TEX. GOV'T. CODE ANN. (Government Code) ch. 2003, Water Code ch. 13, and 30 TAC chs. 80 and 291.

4. Proper notice of the Application was given by the Applicant as required by Water Code § 13.187, 30 TAC §§ 291.22 and 291.28, and Government Code §§ 2001.051 and 2001.052.

5. The Applicant has the burden of proof on all issues in this case. Water Code § 13.184(c).

6. The invested capital amounts set forth in the Findings of Fact above are based on the original cost of property used by and useful to the Applicant in providing service, less depreciation, in accordance with Water Code § 13.185.

7. The revenue requirements are based on Applicant's reasonable and necessary operating expenses, within the meaning of Water Code §§ 13.183 and 13.185 and the Commission's rules.

8. The revenue requirements are sufficient to provide Applicant with a reasonable opportunity to earn a fair and equitable return on its invested capital while preserving its financial integrity, within the meaning of Water Code §§ 13.183 and 13.184.

9. The rates and fees to be charged by Applicant, as approved by the Commission in this Order, are just and reasonable, not unreasonably preferential, prejudicial, or discriminatory, and sufficient, equitable, and consistent in application to each class of customer in accordance with Water Code §§ 13.182, 13.189, and 13.190.

10. The doctrine of collateral estoppel or issue preclusion applies in administrative law cases and precludes the relitigation of identical issues of fact that have been actually litigated between the same parties or those in privity with the original parties. *Coalition of Cities for Affordable Util. Rates v. Public Util. Comm'n*, 798 S.W.2d 560, 564-65 (Tex. 1990).

11. Those in privity with a party may include persons who exert control over the action, persons whose interests are represented by the party, or successors in interest to the party. *Dairyland County Mutual Ins. Co. of Texas v. Childress*, 650 S.W.2d 770, 773-74 (Tex. 1983).

12. Within the context of this case, the affiliated Utility and Land Company are in privity with one another.

13. The doctrine of collateral estoppel applies and bars the relitigation of the Commission's determinations in the 1986 Order concerning the Pre-1985 Assets.

Financial Integrity

14. Water Code § 13.183(a)(2) does not require the Commission to fix a utility's overall revenues at a level that will preserve the financial integrity of a utility when the utility's owners have irresponsibly managed its finances.

15. The Utility has failed to show that its rates should be set at a higher level to preserve its financial integrity.

Approved Rates

16. The Utility's rates should be approved as set out below:

Monthly Rates	**Approved**
Base rate (½" or ¾" inch meter)	
0 to 2000 gal	$0
2001 to 10000 gal	$3.00
10001 to 20000 gal	$4.00
20001 gal thereafter	$5.00

17. The claimed rate case expenses should be disallowed, in accordance with 30 TAC § 291.28(8).

Refunds

18. Unless otherwise agreed to by the parties to the rate proceeding, the utility shall refund or credit against future bills all sums collected during the pendency of the rate proceeding in excess of the rate finally ordered, plus interest, as determined by the regulatory authority. Water Code § 13.187(i).

19. The Utility has been collecting the proposed rates since they went into effect on May 1, 2009.

20. After accounting for interest, the total refunds due customers for overcharges is $ _____.

21. The reasonable rate of interest on the overcharge balance until repaid is _____%.

22. The Utility should refund or credit to customers all sums collected since May 1, 2009, which was the effective date of the rates at issue in this case, that exceed the rates finally approved by the Commission in this case plus ___% interest on the over-collection.

Transcript Costs

23. In accordance with the factors set out in 30 TAC § 80.23, the costs of recording and transcribing the hearings in this case should be assessed as follows:

a) The Protestants should bear the cost of the copy of the transcript, if any, that they ordered for their own use; and

b) The remaining transcript costs should be assessed against the Applicant

III. ORDERING PROVISIONS

NOW, THEREFORE, BE IT ORDERED BY THE TEXAS COMMISSION ON ENVIRONMENTAL QUALITY, IN ACCORDANCE WITH THESE FINDINGS OF FACT AND CONCLUSIONS OF LAW, THAT:

1. The application of Deer Creek Ranch Water Co., LLC to increase its water rates under Certificate of Convenience and Necessity No. 11241 in Travis and Hays Counties, Texas, is approved in part and denied in part. New rates are approved as set out below:

Monthly Rates	**Approved**
Base rate (½" or ¾" inch meter)	
0 to 2000 gal.	$0
2001 to 10000 gal.	$3.00
10001 to 20000 gal	$4.00
20001 gal thereafter	$5.00

2. The Utility should refund or credit to customers all sums collected since May 1, 2009, which was the effective date of the rates at issue in this case, that exceed the rates finally

approved by the Commission in this case plus ___% interest on the over-collection. The refund shall be made over a ___ month period to begin _____.

Transcript Costs

3. In accordance with the factors set out i

4. n 30 TAC § 80.23, the costs of recording and transcribing the hearings in this case should be assessed as follows:

   a) The Protestants shall pay the cost of the copies of the transcript, if any, that they ordered for their own use; and

   b) The Applicant shall pay the remaining transcript costs.

5. All other motions, requests for entry of specific Findings of Fact or Conclusions of Law, and any other requests for general or specific relief, if not expressly granted herein, are hereby denied.

6. The effective date of this Order is the date the Order is final, as provided by 30 TAC § 80.273 and Gov't Code § 2001.144.

7. The Commission's Chief Clerk shall forward a copy of this Order to each of the parties.

8. If any provision, sentence, clause, or phrase of this Order is for any reason held to be invalid, the invalidity of any provision shall not affect the validity of the remaining portions of this Order.

ISSUED:

TEXAS COMMISSION ON ENVIRONMENTAL QUALITY

_____

Bryan W. Shaw, Ph.D., Chairman
For the Commission